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NOMINATION OF MICHAEL J. BOSKIN

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE NOMINATION OF MICHAEL J. BOSKIN, OF CALIFORNIA, TO BE CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

JANUARY 26, 1989

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NOMINATION OF MICHAEL J. BOSKIN

THURSDAY, JANUARY 26, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., pursuant to notice, in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sarbanes, Cranston, Dixon, Sasser, Sanford, Shelby, Graham, Wirth, Bryan, Garn, Heinz, D'Amato, Gramm, Mack, Roth, Kassebaum, Pressler, and Wilson.

OPENING REMARKS OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

We want to welcome our nominee for Chairman of the President's Council of Economic Advisers.

Professor Boskin, we are delighted to have you with us today and you're accompanied by two of our distinguished and senior colleagues, Senator Cranston and Senator Wilson.

I think what we will do initially is hear from them as I know they want to introduce you, then I will have some comments to make and I will ask for the comments my colleagues may wish to make in the way of an opening remark and then we will proceed to questions.

So with that, Senator Cranston, let me recognize you.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Thank you very much, Mr. Chairman.

It's my pleasure to join with my colleague, Pete Wilson, in introduce Michael Boskin of California to the committee.

We all know that he has been nominated for a very important post in the administration. He was born in New York, but his family had the wisdom to move to California. He went to the University of California, Berkeley and earned three degrees there, including a Ph.D. He was given the chancellor's award as the outstanding undergraduate in one of his years there. He has been a professor of economics at Stanford University ever since.

In 1986 he was appointed director of the Center for Economic Research. He has won many professional awards. He is the author of 70 articles and books on economic matters. He is respected, and I think this shows his balance, by academics, by business leaders and by politicians. He has testified often before congressional committees.

I was struck by a quote from a friend of his in a story about him in the Los Angeles Times. This friend said:

> Can you imagine what kind of offers he gets from corporations to be a private economist and what kind of multiples of income that would mean for a college professor? But he honestly believes that it is much more meaningful to try to convince legislators than clients of a Wall Street firm.

He became a key adviser to Vice President George Bush, and typical of the appointees of George Bush, he is no idealogue. Bush said of him last fall:

> I know him well. I depend upon him for sound economic advice.

Another who speaks highly of him is George Schultz, who has been connected with Stanford University.

Let me finally read a couple of things that appeared in a Time Magazine profile of Michael Boskin:

> Boskin's primary concern about the U.S. economy is its low savings and investment rate, a problem he attributes partly to the high deficits.

And plainly, that is one of the major matters where we need the soundest possible economic advice and leadership.

Then as to his colleagues in the economic world among academicians that Time Magazine reported:

> Most of his colleagues are pleased that Boskin was selected. Viewing his appointment is a sign that the Bush administration will be more accessible to outside ideas than his predecessor was.

Boskin certainly hopes that is the case, saying:

> have always taken very seriously the research of all schools of thought. I didn't start out presuming that they were wrong because I wasn't wed to one camp or another.

It seems to me that is the sort of a man we need in this post, and I am delighted to be with him today and to recommend him to this committee.

Michael, thank you.

Mr. BOSKIN. Thank you very much, Senator.

The CHAIRMAN. Thank you, Senator Cranston.

Senator WILSON.

OPENING STATEMENT OF SENATOR WILSON

Senator WILSON. Thank you very much, Mr. Chairman.

I heartily endorse the comments of my friend and colleague, Alan Cranston, and I would point out that Professor Boskin is being introduced this morning not only by a Republican and a Democrat, but by graduates of Stanford and Berkeley. If that is lost upon you, why there is a rivalry of some importance to those who are involved in it.

Now that Senator D'Amato has come, I was going to point out that while we are proud to claim him in California, he is, like a number who have brought energy and wisdom to California, originally a New Yorker.

The fact of the matter is Senator Cranston I think has dwelt quite appropriately upon what is perhaps at once the most significant characteristic of Michael Boskin, both as a student and as a teacher of economics, and the quality that has made him valuable to Democrats and Republicans. Whether he was a consultant to

Ways and Means, as he has been often, or to the Treasury Department, he is not an idealogue, but rather someone who has probed, who has done original research and found pragmatic answers.

He has written extensively, as you were told, and published at great length on the Federal budget. His doctoral thesis, which won outstanding honors, also won the National Tax Association award.

He has for the years that he has been at Stanford not been a remote and cloistered academician, but one who regularly and eagerly met with students and, as has been pointed out, regularly and eagerly met with those other economists who brought to the table a different point of view and has felt more than comfortable in discussing forthrightly and calmly, even with Lawrence Summers, differing economic views.

So Mike Boskin does not with anyone that knows him project the image of a doctrinaire economist. He has rather projected the image of one who has studied problems fully, who has considered a host of proposed solutions, who has considered their impact not only on the macro-economy, but on individuals who will be affected. And then having done so, and having done original research and having tested theories, he has recommended specific solutions that he believes to be the most effective.

It is, I think, a matter that is known to many that while he has been generally credited as the father of the flexible freeze and someone who has agreed with the President that there should not be new taxes, this is not an ideological article with him, but rather it is the judgment that he has come to after a considerable period of time and after observations of the performance of the economy.

In 1985 he supported modest revenue increases as part of deficit reduction, but to quote him:

> As the tax burden stabilized and the economy continued to grow, it became increasingly clear that the surest and safest way to balance that budget was to control the growth of spending permanently.

He has been, as Senator Cranston told you, concerned about what he considers to be an insufficient rate of savings and investment. He has been concerned, as an illustration, of the mix of concern about the macro- economic effect and that on individuals.

He has been one of the staunchest advocates of the IRA as a means of saving, as a means whereby middle-class Americans could find some small way to supplement their retirement and at the same time produce, I might say, in contradiction to the statements of the Joint Tax Committee staff, a very significant new pool of capital available for investment and the creation of jobs through the creation of small businesses.

But you have his curriculum vitae and it is extraordinary, and looking at it, if you didn't know the man, you would assume that he must be about 83 years old rather than the youthful 43 that in fact he is.

It is, I think, very clear that he is a man blessed with extraordinary energy, both physical and intellectual.

A moment ago I mentioned that he has been both a student and a teacher of economics. I think one of the more significant things is that in economics, widely known as the dismal science, he has managed to make it exciting, not only to colleagues, but to his stu-

dents, and one of the more significant things I think is that he has won the Dean's Award for Distinguished Teaching at Stanford University, an award that is granted on the recommendation of both teachers and students.

And to add one more endorsement, a noted liberal economist, Kenneth Arrow, has stated with a succinctness rare in both politics and academe: "He is eminently qualified." I think that understates it. I think he is qualified not only by experience, by training and by intellect, but by character.

I think it was a very significant point made by Senator Cranston that he has chosen what to him is the more rewarding path, not more rewarding in terms of the material compensation that he could earn, but in terms of what Jerry Brown was called psychic compensation, and Jerry wasn't always wrong. [Laughter.]

In that instance I think he made great sense, and I think we are very fortunate that Professor Boskin has decided to earn his psychic compensation by giving good advice not only to the President of the United States, but to others, and I think it's advice to be heeded. I think he is, as Kenneth Arrow has said, eminently qualified to perform the role of the Chairman of the Council of Economic Advisers.

Thank you, Mr. Chairman.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. Thank you, Senator Wilson.

I am going to now make a few comments and invite my colleagues to do likewise, and then we'll go to the nominee ask him for his initial comments and then we'll move on to questions from that point.

I think it is clear from what has been said by the two Senators that have just introduced you that you certainly bring a very distinguished private sector record in academic pursuits and in other activities, and certainly those are important qualifications for the kind of job that you're on the verge of stepping into.

I think that it's fair to say that your destined to be a key player in the new Bush administration and perhaps potentially the most important Cabinet Member or certainly at the very top of the Cabinet for the reasons of the complexity of our economic problems, both opportunities and challenges and difficulties that we see in front of us. Mapping out the economic strategy and convincing the administration and in turn the administration working with the Congress, I think will be critical to the kind of future we are going to have as a country.

So every citizen in America has a stake in our economic future, and your stewardship in that position I think has a direct meaning and bearing on every person in our country.

We will plan to treat your thoughts and ideas and recommendations with great seriousness and with great care as you represent the views of the administration as we go along, and of course that begins today.

I want to say that we wish you well in this endeavor. I admire greatly persons willing to serve in important public capacities. It's a different kind of situation than any you've been in before, as you

are finding, and will increasingly find that this committee wishes you well as you set out on this assignment.

Now as we look at where we are today and as you come on the scene, there are a number of impressive economic achievements that have occurred during the past 8 years. We have had the longest period of peacetime economic growth in our history, 19 million new jobs have been created and the unemployment rate, interest rates and inflation rates are down significantly from the record highs in the early 1980's.

Yet, just under the surface of these achievements are some very disturbing developments. The budget deficit, the trade deficit, corporate debt and household debt have all exploded in size, and according to a report issued by the Conference of Mayors across America, the number of homeless families is increasing now at the rate of 20 percent a year, unprecedented in modern history.

Since 1970, now nearly two decades, worker income in this country has grown in real terms by only ⅓ of 1 percent per year, and that, too, is a rather dramatic change from our earlier experience.

Meanwhile, we are experiencing ongoing investigations of historic proportions in our securities and commodities markets, and the integrity of our capital markets has come into serious question. So there is mounting concern about our economic future and a growing question as to where some of these negative trend lines may be taking us.

As Chairman of the Council of Economic Advisers you will be responsible for advising the President on a wide variety of issues, and we will look forward to hearing your views now and in the months ahead on these issues in particular:

The approach to negotiating our trade relationships with major surplus countries that restrict imports from the United States, a big problem, as you know;

Ways to reduce the budget deficit and the various other high debt levels in our economic system;

Your views and insight on the flexible freeze;

The extent of the FSLIC problem and how you think it might best be financed;

The outlook for continued economic growth versus a downturn in the economy and also the outlook for improvement in the Third World debt situation;

We will also be interested in your views on financial services reform, exchange rate policy, tax policy and whether you feel that any additional reforms are needed in light of last year's stock market break; and

Your thoughts on policies to promote savings and any reaction you might have to recent leverage buyout and merger and acquisition activity as well as the recent investigations into alleged wrongdoing in the securities and commodities markets.

I just say that I am very encouraged by reports that I read that President Bush is preparing proposals to encourage American business, to concentrate more on productivity and growth over the long term and less on immediate profit.

I believe that this will eventually help our international competitiveness, and I welcome with particular interest your views on these issues as well as whether or not you share the belief of some

that our standard of living is gradually eroding, or at least for many citizens, versus that of other industrialized countries.

I especially appreciate your written responses to pre- confirmation questions that Senator Gramm from Texas, Senator Mack and I sent to you. Those have been shared and will be shared with all the members of the committee and will be included in the record.

With that, let me now call on Senator Garn.

Senator WILSON. Mr. Chairman, if I might just intervene, if I may be excused.

The CHAIRMAN. By all means.

Senator WILSON. Thank you very much.

Senator GARN. Should we vote on whether we should excuse him or not? [Laughter.]

We may not let you go, Pete.

Senator WILSON. That's the most flattering comment I've heard actually.

Senator GRAMM. Pete, that wasn't clear to me.

Senator WILSON. I'll write it out for you. [Laughter.]

Senator GARN. Thank you, Mr. Chairman.

OPENING REMARKS OF SENATOR GARN

Mr. Boskin, I'm pleased to welcome you before the committee and I think President Bush has made an excellent choice for an extremely important position in his new Cabinet.

In the interest of time, Mr. Chairman, I will simply ask that my statement be placed in the record. No one came to hear me, Mr. Boskin. We came to hear you.

I will apologize in advance for not being able to stay for the entire hearing. As the usual Senate situation, we have confirmation in another committee that I serve on for Manny Lujan as Secretary of the Interior. So I will have to leave and attend that hearing as well.

I will have some questions that I will submit to you if I am not able to be here at my questioning time for your answer in writing.

So welcome to the committee, and I look forward to working with you over the next 4 years.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator Garn follows:]

STATEMENT OF SENATOR JAKE GARN

JANUARY 26, 1989

DR. BOSKIN, SOME COMMENTATORS MAY QUESTION YOUR JUDGMENT IN ACCEPTING THIS JOB AT A TIME WHEN THE U.S. ECONOMY IN ENJOYING THE LONGEST PEACETIME ECONOMIC EXPANSION IN ITS HISTORY.

IMPLICIT IN SUCH A QUESTION IS AN ASSUMPTION THAT THE ECONOMIC EXPANSION MUST SOON END AND A BELIEF THAT YOU, AS THE PRESIDENT'S CHIEF ECONOMIC ADVISER, WILL GET MUCH OF THE BLAME.

I, HOWEVER, AM NOT ONE OF THOSE WHO BELIEVES THAT OLD AGE WILL KILL THE ECONOMIC EXPANSION.

I BELIEVE THAT CONTINUING TO PURSUE ECONOMIC POLICIES THAT LIMIT GROWTH OF GOVERNMENT AND ENCOURAGE PRIVATE ENTERPRISE WILL MAKE IT POSSIBLE FOR THIS ECONOMIC EXPANSION TO CONTINUE.

OF COURSE, THE TASK BECOMES MORE DIFFICULT AS THE ECONOMY APPROACHES CAPACITY CONSTRAINTS IN MORE AND MORE SECTORS. MR. BOSKIN, YOUR CLOSE PERSONAL RELATIONSHIP WITH PRESIDENT BUSH SHOULD BE OF BENEFIT TO THE NATION IN COPING WITH THESE INCREASINGLY DIFFICULT ECONOMIC-MANAGEMENT PROBLEMS.

FINALLY, I BELIEVE THAT TO ASSURE THE CONTINUATION OF THE ECONOMIC EXPANSION, WE IN GOVERNMENT MUST PROMPTLY ADDRESS EMERGING THREATS TO THE ECONOMY. TODAY NO THREAT IS MORE IMMEDIATE THAN THE PROBLEMS IN THE S&L INDUSTRY.

I HOPE THIS COMMITTEE AND THIS CONGRESS WILL HELP YOU, MR. BOSKIN, BY MOVING QUICKLY TO ENACT A RESPONSIBLE PROGRAM TO COPE WITH THE PROBLEMS IN THAT TROUBLED INDUSTRY.

The CHAIRMAN. Thank you, Senator Garn.

Proceeding in the order in which members arrived this morning, we will call next on Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENTAOR WIRTH

Just being very brief, as everybody has said, and I think quite justifiably, this is an excellent choice for an extremely difficult job.

I just want to confirm the credentials, Mr. Chairman. A number of my more liberal faculty friends at Stanford have written and called me about your appointment and praising that, and that it seems to me is a good ecumenical indication of the excellence of this choice.

My son, who was a student of yours, also confirmed that in fact the teaching award was well deserved.

Mr. BOSKIN. Thank you, Senator.

Senator WIRTH. So we are delighted to have you here. I look forward to hearing you this morning and later on on read my lips. It seems to me that we had an abridgment of that particular statement only the day before yesterday which has swirled around us in the S&L crisis, and I look forward to hearing your comments on how we are going to get ourselves out of this budget mess without doing something on the revenue side. I know you are going to be prepared to talk about that and work with us on that over the coming months.

Thank you very much, Mr. Chairman.

Mr. Boskin, welcome and I look forward to working with you.

Mr. BOSKIN. Thank you, Senator.

The CHAIRMAN. Senator Mack.

I pass, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you very much, Mr. Chairman.

Dr. Boskin, I want to welcome you before the Banking Committee today and say that today the committee considers your nomination to be Chairman of the Council of Economic Advisers, and perhaps given the economic situation the country is in presently this is one of the most important posts that we'll fill in the new administration.

I would say, Dr. Boskin, having read your resume here, you bring great qualifications to this job. You are a man of significant academic achievement and honors and certainly one of the most prolific writers on economic matters that has come before this committee in my years in the Senate. I'm confident that your nomination is going to be approved by this committee and is going to be confirmed by the Senate.

But now having said that, Mr. Chairman, that is not to say that we shouldn't today test the mettle of this nominee and delve into the economic issues of the day and see precisely what his views are on these issues.

In particular I'm concerned about the logic and premise surrounding the so-called flexible freeze, a concept to which Dr. Boskin has been closely connected.

And most of all, I'm concerned about the rosy economic assumptions that underlie the budget of the Reagan administration. The economic assumptions will most likely be adopted by President Bush and, as I understand it, are espoused by you, Dr. Boskin. These assumptions that are diametrically opposite to the economic view being taken by the Federal Reserve.

Now it's well known that I differ with Dr. Alan Greenspan on a number of issues dealing with monetary policy and interest rates, but the fact is, and I put this directly to Dr. Boskin, Alan Greenspan's views on the course of this economy are going to be more determinative of the direction of interest rates and economic growth in the short term than any other factor that I can think of, and I think it's something that we're simply going to have to face up to.

Dr. Greenspan said Tuesday before the House Banking Committee, and I quote him: Current inflation rates are too high and must be brought down.

Now, Mr. Chairman, that appears to me that that means that either we work for meaningful deficit reduction now or the Federal Reserve Board is going to raise interest rates further that will push us toward a recession that we can ill afford.

President Reagan's budget, the flexible freeze and the prospective Bush budget all assume sustained economic growth of over 3 percent per year for the foreseeable future.

On now the Federal Reserve says, the other hand, that we can't possibly grow faster than 2½ percent per year, and the blue chip consensus says that it's more in the neighborhood of 1.7 or 1.8 percent, certainly below 2 percent. The problem that concerns me is the Federal Reserve may not allow us to grow faster than their economic predictions.

In the Fed's view, if the economy overheats, they will simply raise interest rates and undercut the 3 percent OMB economic assumptions. On the other hand, if the Fed does not raise interest rates, it will only be because economic growth has been relatively flat and again OMB and its 3 percent assumptions will be wrong.

In short, it appears to me that the Federal Reserve has us here in a Catch-22 situation. They are not going to let the economy grow at the 3 percent that OMB predicts even if those were accurate predictions.

I think the time has come for what I believe are honest economics. Interest rates are already almost 2 percentage points higher than those assumed in President Reagan's budget in his economic assumptions. That in and of itself raises the deficit by approximately $17 billion, give or take a few billion, and the economists don't agree precisely on how much a 1-percent raise in interest rates does raise the deficit.

But most of all, and I think our distinguished Chairman will agree with me on this, we can't continue borrowing instead of making the needed investments in our social and economic infrastructure. Otherwise, I think, Dr. Boskin, you and those of us in the Congress will be the architects of the economic decline of the

United States, and perhaps worse, we will be leaving a legacy of debt and social decay for our children.

So I look forward this morning in hearing Dr. Boskin's responses to the questions that are being propounded to him, and I congratulate the President in offering such a distinguished nominee.

Thank you.

The CHAIRMAN. Thank you, Senator Sasser. I think you pose some very important points there.

Senator D'AMATO.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I have a number of questions that I'm going to ask be submitted for the record, with the committee's approval, in regard to this outstanding nomination by our President.

I would only put in an aside. I hear some of these statements and I understand the concern as it relates to FSLIC and some of the other matters and how we are going to deal with the deficit, but I didn't get this picture of doom and gloom. I thought unemployment was pretty good and I thought the interest rates historically, given where we have been, are not too bad.

Sure, we've got to be concerned, but this is not a picture of doom and gloom. I think it's one of some prosperity and how do we continue that and how do we protect that and how do we nurture it. So I think that the administration has done a pretty good job, and I think we in the Congress now have got to come forth and we're going to be called upon to help as it relates to reducing the deficit of maybe giving up a little bit here and there on some of our favorite programs and trying to use some restraints.

It's not always easy because everyone wants to protect their favorite program, but certainly I think Dr. Boskin is the kind of person who brings the intellectual capabilities to help lead this Nation in dealing with some of the problems that members of the committee have mentioned, and I'm delighted that as a former New Yorker he has landed on his feet. That is not always the case, and of course that beautiful land of California, I would never let my children go out there because they would probably never come back. [Laughter.]

It's good to see you, Dr. Boskin.

Mr. BOSKIN. Thank you, Senator.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you, Mr. Chairman. I'll be very brief.

I want to join my colleagues in welcoming Michael Boskin before the committee.

I have more than a passing interest in the Council of Economic Advisers since as a young man I worked for Walter Heller when he was the Chairman of the Council, perhaps its most distinguished Council since it was established by the Employment Act of 1946, and as Chairman of the Joint Economic Committee in the last Congress, we of course worked very closely with the Council of Eco-

nomic Advisers and I expect that close working relationship to continue in this Congress.

The Employment Act provides that the President shall appoint three members to the Council by and with the advice and consent of the Senate, each of whom shall be a person who as a result of his training, experience, and attachments is exceptionally qualified to analyze and interpret economic developments, to appraise programs and activities of the Government and to formulate and recommend national economic policy to promote full employment, production, and purchasing power under free competitive enterprise.

It's a broad and serious mandate that is placed upon Dr. Boskin, and I assume two new colleagues whose nominations will be sent to us in the near future.

I look forward to the opportunity to question him this morning and I wish him well as he embarks on this endeavor.

Mr. BOSKIN. Thank you, Senator.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, thank you.

Dr. Boskin, I want to make it clear that this is not the funeral for the American economy that you have attended today, despite all the black crepe, nor do I feel terribly sorry for you at this terrible task that you're undertaking in the midst of things going to hell as they are described to be by so many here today.

In 1981, when your predecessor at the beginning of the last administration was before this committee interest rates were 21.5 percent, on a quarterly basis the inflation rate was 18 percent, taxes as a percentage of GNP were at the highest level that they had been since the Second World War, save the 1 year when we had the surcharge of the Vietnam war we are entering a recession, and the economy was not generating jobs, growth or opportunity nor revenues for the Federal Treasury.

Today amidst all this black crepe that is being strung in your path here you have the difficult task, even by the assessment of the democratically controlled Congressional Budget Office, of dealing with a budget problem where revenues are up by $86 billion because of the strength of the economy.

You have the herculean task with that $86 billion of putting $55 billion of it toward deficit reduction and limiting the growth of Federal spending to $31 billion, which is about a 3 percent growth in Federal spending the way the guy in the street defines the problem.

To any business or family in America that would be child's play. It's not child's play here because we have set a priority on increased spending in this Government since the Second World War.

So I think you do have a tough task, a lot of it in dealing with Congress. The plain truth however, is that you have more things going for you, you have a stronger fundamental economy than any person who has taken this position that you no doubt will be confirmed for next week has had in the entire post-war period.

So my simple advice amidst all the gloom and doom is, don't blow it. [Laughter.]

Try to build on what we have done and make it better. And I can say with a little expertise, having once been an academic myself, that you are what we call in Texas a top hand. I am glad that you're going to be there advising our new President. Our new President has many abilities that I admire, but one of them is that he is an excellent listener, and he is going to be the kind of hands-on/get- involved/get-the-job-done President that we need.

I think your advice is going to be very valuable to him, and I look forward to working with you. You will get plenty of advice from us, I can assure you. If you will filter all that out and then give your advice to the President, I will be grateful. I look forward to voting for you for this high office.

Mr. BOSKIN. Thank you, Senator.

Senator GRAMM. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Mr. Chairman, I would yield my time at this point and reserve it for questions.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

I would just like to say welcome. It's an excellent appointment and I look forward to hearing Dr. Boskin's comments.

Mr. BOSKIN. Thank you, Senator.

The CHAIRMAN. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman.

I am pleased to be here this morning as the Banking Committee considers the nomination of Michael Boskin to be Chairman of the Council of Economic Advisers. I look forward to hearing Mr. Boskin's views on the major economic problems facing our Nation.

At the outset I would simply like to make one point. I hope that Mr. Boskin will use his position to bring greater honesty to the economic forecasting process in the Federal Government. Economic projections from the past administration virtually all were on the optimistic side. Now I'm the first one to admit that this optimism has had some sort-term benefits, Mr. Boskin.

It has enabled us on a number of occasions to say that we were in compliance with the Gramm-Rudman-Hollings targets when of course the truth was that we were not in compliance.

Because the actual deficits are often too much greater than the forecast deficit, we are destroying the public confidence in government that is so vital to our system. I think it's a serious mistake to address the American public as if we are in Orwell's Brave New World. We ought not to speak to the American public in Orwellian newspeak. We ought to be honest with every American on the budget problems we are facing and what it will take to resolve those problems and, Mr. Boskin, I look forward to hearing your comments on that in the course of your discussion.

Mr. BOSKIN. Thank you, Senator.

Senator DIXON. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Dixon.

Before calling on Senator Roth, if I may exercise a privilege of the Chair, I just want to make a personal comment, and that is

that Senator Roth is a new member to the Banking Committee and this is his first time to come to the committee.

I want to just reminisce for a minute about the fact that Bill and I came to the Congress together 22 years ago with a group of other new Members of Congress who included George Bush and a wide variety of other individuals. We have served together over that period of time in both the House and the Senate. This is the first opportunity we have had to serve on a committee together, and I'm just delighted that we're having that chance.

I am pleased to have you as a member of the committee and would like to call on you at this point.

OPENING STATEMENT OF SENATOR ROTH

Senator ROTH. Well, thank you very much, Mr. Chairman.

As I recall, back in those days there was a lot of talk about a Bush/Riegle ticket, but somewhere along the way you got off track as I recall. [Laughter.]

But I am delighted and I look forward to serving with you on this most important committee which I think has a number of key problems before it.

As some of the others have said, I'm delighted with the President's nomination of you as Chairman of the Council of Economic Advisers because I think the most important problem we face as a nation is to become competitive in this emerging global economy.

I don't accept, Dr. Boskin, this pessimism that one finds so much in Washington as to where this country is going, not that I deny that we have some very, very serious problems, but I think that the economic successes of the Reagan administration are considerable and what we need to build upon.

What I shall be particularly interested in hearing from you later on are your thoughts as to how we continue to grow and how this expansion can be continued for the foreseeable future.

And most importantly of all is what we do about personal savings. I think individual savings is a must if we are to become competitive, and I was interested as I came down on the train from Wilmington this morning when the conductor on the train came up to me and what do you think of taxing our savings in the banks? He said, that just seems to be that all they are trying to do is kill off individual savings with IRA's and so forth.

So I'll very very much be interested in your comments in this area, but I welcome you here today.

Thank you again, Mr. Chairman.

Mr. BOSKIN. Thank you very much, Senator.

The CHAIRMAN. Thank you, Senator Roth.

Now, Mr. Boskin, there is an oath that I have to administer. So I'm going to ask you, if you will, to stand at this point and respond and raise your right hand.

[Dr. Boskin stands and raises his right hand.]

Do you swear that the testimony that you are about to give is the truth, the whole truth and nothing but the truth, so help you God?

Mr. BOSKIN. I do.

The CHAIRMAN. Do you agree to appear and testify before any duly constituted committee of the Senate?

Mr. BOSKIN. Yes, sir.

The CHAIRMAN. Thank you. Be seated, please.

We are going to go in short time periods here so that we can accommodate as many rounds as possible in the time we have this morning.

So when you finish your opening statement, we will go back and forth across the table, but we are delighted to have you and we would be pleased to hear your opening comments now.

STATEMENT OF MICHAEL J. BOSKIN, NOMINATED TO BE CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. BOSKIN. Thank you, Senator, and I thank everyone else on the committee for their opening statements.

Mr. Chairman, distinguished members of the committee, it is an honor for me to appear before you today as the President's nominee to be Chairman of the Council of Economic Advisers.

As was mentioned by Senator Sarbanes, there is a long and distinguished list of persons who have preceded me in that job. He mentioned Walter Heller. That list includes Alan Greenspan, Arthur Burns and many of the most eminent members of my profession.

Let me especially thank my home state Senators who have had to go to other hearings, Senator Cranston and Senator Wilson, for doing me the high honor of introducing me today, especially in light of their exceptionally busy schedules.

Since my designation, it has been a pleasure to visit with most of you personally. I welcome these early opportunities to discuss the many economic priorities we face as we begin a new Congress and a new administration.

From the outset I want you to know that I am committed to a continued frank and frequent dialog with Congress. Not only do I appreciate your input, but I believe it is an integral part of the workings of the Council of Economic Advisers.

Most of the time since my designation, however, Congress has been in recess, and while I met with several of you as late as yesterday, I have not had the opportunity to personally meet with a few members of the committee. I look forward to meeting with all of you soon.

Prior to my recent nomination, I served as Wohlford Professor of Economics and Director of the Center for Economic Policy Research at Stanford University. I have in the past worked closely with the Joint Economic Committee starting in the mid to late 1970's and with committees in both the House and the Senate on a broad range of economic policy issues, and I have acted as an adviser to various government agencies.

It is with this background that I come before this committee to seek confirmation as Chairman of the Council of Economic Advisers.

One of the greatest challenges facing us today is the continuation of what has been the longest peacetime economic expansion in the post-war history of the United States. Though no single policy can guarantee the continued growth and stability of our economy, the

administration is committed to a set of basic principles aimed at achieving this goal.

As Chairman of the Council of Economic Advisers, if I am confirmed to that office, I will advise President Bush on all aspects of economic policy. I know that the advice I give will be one important input into decisions that will affect the economy in this country and the world, impacts that are directly felt by your constituents.

The issues that concern the American public, the budget deficit, price stability, growth in employment and family incomes, the functioning in various markets and the health of various industries, to name but a few, are matters that the Council of Economic Advisers will address and analyze. It will be our task to provide the soundest possible advice to President Bush and other members of the administration.

Mr. Chairman, as I have indicated to you personally, the recommendations made by the Council of Economic Advisers will be based on a clear, rational, and comprehensive view of the economic environment.

I assure you that we will be diligent in our efforts to continue our country's noninflationary growth and ours will be a collaborative effort to respond to the economic concerns of the nation and to anticipate the everchanging trends of the national and global economy.

In conclusion, I would like to take this opportunity to thank the entire committee, and especially you, Mr. Chairman, for the expeditious consideration you have shown me of my nomination.

Mr. Chairman, I would be happy to answer any and all questions you and the other members of the committee may have.

[The complete prepared statement of Presidential Nominee Michael Boskin follows:]

Introductory Statement of
Dr. Michael J. Boskin

Nominee for Chairman of the Council of Economic Advisers before the Senate Committee on Banking, Housing and Urban Affairs

January 26, 1989

Mr. Chairman, distinguished members of the Committee, it is an honor for me to appear before you today as the President's nominee to be Chairman of the Council of Economic Advisers. Let me especially thank my home state senators, Senator Cranston and Senator Wilson, for doing me the honor of introducing me today, especially due to their exceptionally busy schedules.

Since my designation, it has been a pleasure to visit with most of you personally. I welcomed these early opportunities to discuss the many economic priorities we face as we begin a new Congress and a new Administration. From the outset, I want you to know that I am committed to a continued frank and frequent dialogue with Congress. Not only do I appreciate your input, but I also believe it is an integral part of the workings of the CEA.

Most of the time since my designation, Congress has been in recess. While I met with several of you as late as yesterday, I have not had the opportunity to meet personally with a few members of the Committee. I look forward to meeting with all of you.

Prior to my recent nomination, I served as Wohlford Professor of Economics and Director of the Center for Economic Policy Research at Stanford University. I have, in the past, worked closely with the Joint Economic Committee and with committees in both the House and the Senate on a broad range of economic policy issues, and I have acted as advisor to various government agencies. It is with this background that I come before this Committee to seek confirmation as Chairman of the Council of Economic Advisers.

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As Chairman of the CEA, I will advise President Bush on all aspects of economic policy. I know that the advice I give will be one important input into decisions that will affect the economy in this country and the world--impacts that are directly felt by your constituents. The issues that concern the American public--the budget deficit, price stability, employment and income growth, the functioning of various markets and industries, to name but a few--are matters that the CEA will address. It will be our task to provide the soundest possible advice to President Bush (and other Administration officials).

Mr. Chairman, as I have indicated to you personally, the recommendations made by the Council of Economic Advisers will be based on a clear, rational and comprehensive view of the economic environment. I assure you that we will be diligent in our efforts to continue our country's non-inflationary growth. Ours will be a collaborative effort to respond to the economic concerns of the nation and to anticipate the ever-changing trends of the national and global economy.

In conclusion I would like to take this opportunity to thank the Committee for the expeditious consideration of my nomination. Mr. Chairman, I would be happy to answer any questions you and the other members of the Committee may have.

The CHAIRMAN. I thank you very much for that comment. We have been joined by Senator Sanford, and before we begin the questioning, did you have a comment that you wanted to make?

Senator SANFORD. Thank you very much. I apologize for not being here but, as you know, I had another hearing. I believe in the interest of time, I will ask permission to put my statement in the record and just wait until I get a chance to ask questions.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman. I appreciate your efforts in moving quickly to the consideration of this important nomination.

Given the crucial economic decisions that are facing this country, it is imperative that the Council of Economic Advisers provides top-notch economic advice both to the administration and to Congress. I believe that your expertise, Professor Boskin, particularly in the areas of taxation, savings, and governmental economic policy, should prove extremely valuable in this effort.

We are all concerned about a number of disturbing trends in our economy—the staggeringly low rates of savings, the tremendous debt incurred by our corporations as a result of leveraged buyouts or takeovers, the growth in consumer debt, and of course the massive Federal deficit. We will need creative ideas to solve these problems, and I hope that we can look to your advice for insight on the proper Federal approach to each situation.

Most of all, I hope that the Council of Economic Advisers will once again be willing to look at the economy honestly, and to provide the President and the Congress with sound advice on the probable, future, economic direction of the Nation. I hope the time has passed when the true nature of our budget problems will be papered over by unrealistic, rosy projections of very low interest rates and very high growth rates.

I also believe that we must change the way the budget is presented, particularly in regard to the inclusion of trust funds, such as Social Security, within the budget. These trust funds cannot be used for general purposes, or to offset the real deficit, and consequently should not be comingled in the budget. They serve only to mask the true nature of the Nation's deficit. To help the Congress promote an honest vision of the Nation's budgetary situation, the Council must play a more effective role in providing accurate economic information.

While I support sincere efforts to reduce the deficit, I am not optimistic that the "flexible freeze" plan, that you have been instrumental in developing, can truly bring about deficit reduction. For example, a total freeze on Defense outlays from 1987 through 1989 would have saved $12 billion, while a similar freeze on International and Domestic Discretionary accounts would have save only $23 billion. Such savings might be commendable, or they might severely damage important functions, but they would not balance the budget. The situation is complicated by our inability to freeze interest payments. Nontheless, I look forward to discussing the plan with you in greater detail.

There is no doubt that you will face many difficulties in projecting the future direction of the economy. I look forward to working with you in the years ahead and to discussing some particular issues with you this moring.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sanford.

Let me say at the outset before I pose my first question that I appreciate the spirit of your comments this morning and the opportunities we've had, you and I and others on the committee, to meet and talk with you informally and privately before today, and I think we are off to a very good start in the kind of dialogue and discussion back and forth that good policy- making requires and should have.

So in any case, we appreciate the tone of those remarks on your part, and we hope to reciprocate on our part.

Let me get into some of the things that are a little tougher and harder to of deal with but need to be dealt with.

One of the concerns that has been expressed with respect to views that you may have and bring in to the deliberations of the economic strategy of the administration has to do with the future of Social Security, and you have been quite direct and outspoken in your views on that.

You've written a couple of very significant books, one called "Too Many Promises" and another one called "Reagan And The Economy," and in those two books I want to just cite two or three quotations as a foundation for the question that I want to pose to you.

In the book called "Reagan And The Economy" published in 1987, relatively recent works on your part, you said as follows:

"Spending can be controlled only by a major attack on middle-class entitlements.

I'm going to move to two or three, and I don't mean to suggest that these ran back to back in your book.

Social Security pays well-off elderly people many billions of dollars more than what they and their employers paid in, plus interest.

Another quote:

The first task is to decouple well-off recipients in government transfer programs such as Social Security in favor of those who are needy. Welfare for the wealthy can no longer be afforded.

In your earlier book of the year before, "Too Many Promises," 1986:

Social Security provides the wrong kinds of benefits and improper amounts to people who did not pay for them.

Another quote:

Social Security is moving toward financial insolvency.

Another quote:

I am in somewhat sympathy with those who would like to privatize part of some of the components of Social Security beyond minimally adequate coverage.

Social Security is an inefficient and inequitable system that transfers wealth in perverse ways.

We face the somber prospect of having to provide government financing for the retirement of a much larger percentage of our population for an ever longer proportion of their lives,

And it goes on in that vein.

I take all of those, and they are obviously taken out of the context in which they were written, but I tried to give a blend here to establish the fact that you've obviously had and express very serious reservations about the Social Security system, how it works and how it goes on in to the future.

There are many of us who feel very strongly about the importance and the need and the solvency and the strength of the Social Security system both in and out of the Congress.

So I would like to begin by asking you should we read into what you have said before the notion that you may be an advocate for some kind of change to the Social Security system? Do you envision proposing now or later some kind of a shifting of the system in some fashion or a change in the benefit structure? I know you've in the past expressed yourself as being not terribly sympathetic to the COLAs.

So where are you on this issue, and can we anticipate some kind of an initiative aimed at Social Security somewhere along the line here?

Mr. BOSKIN. Thank you, Senator, and thank you for highlighting those books. Maybe we'll sell a few more copies because of it.

Let me just say, as with most books, they tend to appear about 1 to 2 years after you did the writing, and we are a couple of years later still, but let me try to place my remarks in perspective.

I have always, and in those two books remained a strong advocate of a strong, sound Social Security system. I have never suggested other than adjustments to what I consider to be the single-most important and successful social program in the United States.

Social Security has prevented millions of elderly citizens from falling below poverty. It is a primary reason why the incidence of poverty among the elderly, which used to be much, much higher, than the average incidence of poverty as recently as the early 1960's, is now at about the level of the general population and by some measures a little bit below that of the general population.

So I start out as a strong defender. One might take what I view as two extreme views that have existed in the 1970's and early to mid 1980's. One that was expressed by some extreme conservatives is that there is no equity or efficiency reason to have this as a government program. I strongly reject on both grounds those arguments.

I believe it is both for fairness reasons and for efficiency reasons to provide types of insurance that cannot easily be provided in private markets, such as inflation indexed joint survivor annuities that guarantee the recipients an inflation index benefit until death that cannot easily be provided in the private market and because of the fairness issue involved that Social Security is one of our most important programs.

Second, through the years the Social Security system has had various financial and other problems associated with it. In both 1977 and 1983 Congress enacted major reforms of Social Security. I endorsed those. I was one of those who as early as the late 1970's in

testimony before the Senate Budget Committee and other committees indicated some of the longer-term financial solvency problems, and that led in part to some of the recommendations of what was then called the Greenspan Commission, the National Commission on Social Security Reform and many of the changes that Congress adopted and the President signed in 1983 which sought to restore the short-run financial health and build up more of a buffer against a recession and to restore some long-run financial solvency.

I also in my second book, the one expressly on Social Security, expressed a great deal of concern about the complexity of the Social Security system and about the fact that it was very difficult for many people as they approach retirement to obtain the same kind of detailed information about their future or likely future Social Security benefits as they would receive, for example. from analogous private pensions.

I was pleased to see in the last year the Social Security Administration made steps to move toward providing that information earlier and on a more timely basis to assist our potential retirees to obtain that information to plan for their retirement.

All that said, I think that it is clear as a factual matter that Social Security does provide benefit payments above and beyond what some people paid in, plus their employers, plus interest, and some of those people are very well off. That was the basis upon which I made some of the statements you referred to, Senator, about the fact that there were some very wealthy people receiving the benefits out of the taxes being paid by workers today.

With all that said, I believe we have made giant strides to putting Social Security on a much sounder, long- term financial footing. The Social Security system is now building a surplus, and in one of those books I said that we ought to make sure we guard that surplus.

The CHAIRMAN. We'll come back to that just a little bit later. I don't want to stop you because you're giving a thorough answer and we want that, although my time is up and I know we have a number of colleagues——

Mr. BOSKIN. Let me just add one sentence then, which is that President Bush has made it clear that Social Security cuts are off the table. I do not advocate any Social Security cuts, and I think the proper way to think about what I have advocated in yesteryear has been to try to improve and strengthen the Social Security system and not to replace it.

The CHAIRMAN. So we **should** not then anticipate that you're going to making any recommendations in the foreseeable future for restructuring of Social Security?

Mr. BOSKIN. That is correct, sir.

The CHAIRMAN. Thank you.

Senator Heinz, you were here previously, and you're next in the order here.

OPENING REMARKS OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I don't wish to take time with an opening statement. I'll wait for my turn for questions, but I do particularly want to welcome Mr. Michael Boskin before this commit-

tee. I feel that I know him well. I've read many of his writings and I think that he is an excellent nominee, and I commend President Bush for nominating him for the position of Chairman of the Council of Economic Advisers.

The CHAIRMAN. Senator Heinz, Senator Mack had to leave and that makes you next in the order. So if you want to use this opportunity to raise questions.

Senator HEINZ. Mr. Chairman, I do have a number of questions. I suspect I won't have time to get through all of them. I hope there is going to be a second round, if time permits.

I would like to ask a question that has to do with the savings rate in this country. Mr. Boskin, I believe that you have some concerns about the savings rate in this country being too low?

Mr. BOSKIN. Certainly, sir.

Senator HEINZ. In that connection, we have had hearings in the Finance Committee on the question of how we might encourage people, first, to invest more for the long term and, second, to invest more in equity rather than debt. It has been proposed that we should eliminate or phase down the double taxation of dividends. Would you generally agree?

Mr. BOSKIN. I would agree that that is a good idea, sir, subject to making sure we could afford it. I would be concerned about the revenue loss. I think we must be cautious that things we do to encourage private saving and investment do not wind up increasing government borrowing and therefore washing on national saving. But I certainly think the elimination of the double taxation of dividends is a good idea.

Senator HEINZ. So as a practical matter while you favor that, you don't see us being able to afford it absent a miracle.

Let me ask you this. If there was a simple way where we could substantially enhance the national savings rate without raising taxes, would you favor that?

Mr. BOSKIN. I would be the first person leading the cheers.

Senator HEINZ. Well, there is an opportunity.

Mr. BOSKIN. I would be glad to hear about it.

Senator HEINZ. We need to implement reform in the budget process. As I think you are aware, currently the annual surplus in Social Security in this fiscal year will run approximately $45 billion and in fiscal year 1990 will amount to some $60 billion. These surpluses contemplated by the Commission that you mentioned, the Greenspan Commission, on which I was privileged to serve. The object of building up a surplus in the Social Security account was to make sure that there would be benefits for the baby-boom generation when they retire.

Right now under Gramm-Rudman-Hollings, the Social Security surplus is counted as if it is deficit reduction. Apart from the fact that it misrepresents, at least in my view, how well we are doing our job in bringing down the deficit, the problem is that we will have two deficits to contend with; the existing national debt currently around $2.5 trillion publicly held, and another debt held by the Social Security accounts of an equal amount, another $2.5 trillion by the end of this coming decade. This is because we are borrowing from Social Security and thereby incurring that obligation, and spending it as if it were money in the general fund.

A large number of economists have said that if you really want to increase the national savings rate you ought to stop borrowing and spending that money and simply allow the funds to accumulate. If you did that, those funds would continue to be invested instead of them being lent to the Treasury. Social Security, in effect, could over the next 15 years purchase the entire publicly held national debt.

If we permitted that plan to operate, what effect would it have on our capital markets and savings rates?what would be the effects of that policy on our country's savings rate and on the economy generally? Would the savings rate increase? Would interest rates drop? Would that policy make it possible for us to be more competitive and more productive? If not, why not?

Mr. BOSKIN. Well, Senator, let me first say that the general idea of building the surplus and not spending it on other things, the idea of as we move toward the Gramm- Rudman-Hollings targets and balance the budget in fiscal year 1993, at that time there is projected to be a situation where while the unified budget will be in balance, Social Security will have a large surplus and the non-Social Security part of the unified budget will have a corresponding deficit.

I think that we need to move the unified deficit down gradually for macro-economic reasons, and that is the goal of Gramm-Rudman-Hollings and I applaud that, but I think that as we move beyond that we ought to give serious consideration, as many of you have said and as Federal Reserve Chairman Alan Greenspan said, to trying to get our overall fiscal stance into a surplus position.

One method of doing that would be to accrue a large surplus in Social Security and to avoid the temptation to spend it on other things later.

There are conflicting estimates of exactly how soon this will occur. The Social Security Administration presents alternative scenarios, as I'm sure most of you know, based on how rapidly the economy grows and the presumed inflation rate and labor force participation and morality patterns and things of that sort.

But most of those projections show that sometime, and many people put this in around the year 2010 or 2015 and certainly we'll approach that sooner, Social Security would be in a position to hold a pretty large fraction of the national debt.

It seems to me that gives us a tremendous opportunity and would present our Nation, Congress and the administration, our regulatory apparatuses a likewise problem. It is one way to increase the national saving rate, which I believe is a key to raising our long-term perspective, to lower interest rates, which is, by the way, the best way to increase the long-term perspective of people, to have them discount the future at a lower rate rather than a higher one.

I believe it would be generally beneficial, and I also believe it would have the generally desirable social consequence of limiting the potential friction that might occur, which I hope would not occur, but might occur if we didn't occur that surplus and had a more abrupt transition to the baby-boom generation's retirement. So in general I think that is a good idea.

Let me say if we do accrue that large surplus, you will soon in your roles on this committee and others, be confronting the issue of what assets the Social Security surplus ought to be invested in. Should they be allowed to invest in things other than special obligation bonds, and that raises a whole host of economic——

Senator HEINZ. Wouldn't that be a wonderful problem to face?

Mr. BOSKIN. Yes, it would be terrific, but it would be a challenge. I have my reservations about whether I would want the Social Security Administration or any other part of the government to own let's say 10 percent of——

Senator HEINZ. In fairness to other Senators, I think we should discontinue that speculation that assumes that we had bought up all the national debt first. I would love that to happen, but we are not there yet.

Mr. BOSKIN. That's correct, Senator.

The CHAIRMAN. Thank you, Senator Heinz.

I'm going to try as best we can, these are complicated subjects and they are very difficult to deal with even with a single question in detail in the 5-minute period with so many Senators present, I want to try and stay as close as I can and be courteous at the same time. So if we can all be mindful of that, that will help us make sure everyone participates.

Senator SASSER.

Senator SASSER. Thank you very much, Mr. Chairman.

Dr. Boskin, it has been indicated here this morning that you're one of the architects of the flexible freeze. I've been curious about that and it has been difficult to get all of the particulars on what constitutes a flexible freeze. As I understand the concept, the flexible freeze has within it the concept of holding spending to the rate of inflation in all areas of government spending, except defense, except Social Security and of course except interest because we have no control on what we pay for intersest on the Federal debt, and it calls for no new revenues; is that correct?

Mr. BOSKIN. Almost, sir. The flexible freeze in its general form, and as announced by then candidate Bush, specifically excluded Social Security and it contemplated no new taxes. There are obviously revenues that occur because of economic growth and there are previously legislated taxes, for example, there would be a tiny increase in Social Security taxes next year.

Senator SASSER. Well, how about defense? Is defense excluded from the flexible freeze?

Mr. BOSKIN. In its general formulation it was not.

Senator SASSER. It was not excluded?

Mr. BOSKIN. That's correct.

Senator SASSER. So in the concept of the flexible freeze we include a freeze on defense spending.

Mr. BOSKIN. In the concept of the flexible freeze any increase in any one program would have to be offset by slower growth of another. So no particular program would necessarily be frozen, defense or otherwise, but if defense grew more rapidly than inflation, something else would have to grow less rapidly, and conversely if some nondiscretionary, nondefense program grew more rapidly, something else would have to grow less rapidly.

Senator SASSER. Well, the new President in advancing the flexible freeze, I assume that the new President would also make the decisions as to what would be done about a major component like defense spending. Am I correct in saying we are hearing this morning, Dr. Boskin, that defense is not excluded from the flexible freeze or that it's included? That's the question I'm asking, or do you know?

Mr. BOSKIN. It is generally included, but it does not mean that defense will be frozen. It just means it's part of the pot when the average is frozen.

Senator SASSER. So, as you view the flexible freeze, defense would be included and it would be subject to a freeze or the rate of increase of defense spending would be held at the rate of inflation?

Mr. BOSKIN. No, sir, and let me clarify that. It's in the pot of things which on average will be held to the rate of inflation. If the President decides to propose a defense increase higher than the rate of inflation, the flexible freeze will require those funds to come from other things growing less rapidly than the rate of inflation. The President may or may not decide to freeze defense, but it's in the general pot of programs and government spending that is subject to an overall average freeze.

Senator SASSER. Well, what do we do about programs that are growing faster than the rate of inflation? Now Medicare and Medicaid are growing at the rate of about 11 percent a year. So that's going to put them about 6½ or 7½ percent ahead of the rate of inflation. We've got veterans 'health care, for example, that is growing considerably faster than the rate of inflation. Does the flexible freeze take into consideration funding for Superfund, for example, to clean up toxic waste sites, and does the flexible freeze take into consideration housing programs, for example, that have been cut by 70 percent since 1980, according to the figures that I've been handed? In other words, will these programs be allowed to grow faster than the rate of inflation?

Mr. BOSKIN. In the concept of the flexible freeze they are subject to the prioritization of the President and then the Congress. In your own budgetary priority setting the idea of being flexible was to allow some priority setting so some things, some high priority programs could grow more rapidly than inflation either because the President and the Congress decided that was desirable, or there may be some demographic or other reasons why they would naturally grow a little more rapidly than the rate of inflation. The idea was to make up for it through slow growth in other spending programs.

So the basic answer to your question is you have to think of the flexible freeze as the overall level of spending other than Social Security growing at the rate of inflation.

One of the aspects of why the word "flexible" was used to allow priority setting is there are some programs that then candidate Bush and now President Bush believes should grow more rapidly than the rate of inflation. In the campaign he mentioned AIDS research, drug enforcement and so on. Therefore, if those do grow more rapidly than the rate of inflation, we will have to make up that additional revenue with a little slower growth in other programs. That's the idea, sir.

Senator SASSER. Well, I can understand the overall idea, but then if we follow that approach there is really nothing new about the flexible freeze. In other words, what you're saying is we are just going to establish spending caps and nothing can grow beyond the rate of inflation except Social Security and then we make decisions and we prioritize the spending levels then, some things can grow faster than the rate of inflation and some less.

Mr. BOSKIN. That is the idea, and certainly this idea has been discussed in many previous Congresses. There are a variety of reasons it was developed and pronounced. There was some discussion, Senator, as you recall after the stock market decline in October and as the budget summit started and as the Presidential campaign heated up of an across-the-board item-by-item freeze, and I thought there were many reasons why that would be less desirable.

It would remove the opportunities for the President and the Congress to exercise their leadership in the setting of priorities, it would guarantee an increase of programs that perhaps didn't deserve it, and it would prevent an increase from other higher priority programs.

Senator SASSER. Well, are we ever going to see an itemization of how the so-called flexible freeze will work at any juncture? Will that be in President Bush's budget?

Mr. BOSKIN. It certainly will, sir. The President will present his budget proposals, as you know, to a joint session, and certainly this will be laid out in some detail. I have to say that no final decisions have been made, alternatives are being discussed and explored.

I am not yet a member of the administration. I have certainly participated in general discussions and we are bringing options and alternatives to the President, but no final decisions have been made.

Senator SASSER. Thank you, Dr. Boskin.

The CHAIRMAN. Thank you, Senator Sasser.

Just as a point of clarification, is the Social Security surplus that Senator Heinz spoke about, available to be spent within the concept of the flexible freeze, just basically yes or no?

Mr. BOSKIN. Yes, the flexible freeze was based on the unified budget concept as was Gramm-Rudman Hollings.

The CHAIRMAN. So the answer is yes. The flexible freeze assumes that you can have access to and use and spend the Social Security surplus?

Mr. BOSKIN. For the next several years as in current law and in Gramm-Rudman Hollings.

The CHAIRMAN. Very good. Thank you.

Senator Gramm is next, but let me just acknowledge the arrival of Senator Pressler.

Senator Pressler, Senator Gramm is next to question, but would you want to make a brief initial comment before he begins?

Senator PRESSLER. Thank you Mr. Chairman. Dr. Boskin, I wish to join in welcoming you in your appearance before the committee. You arrive with high credentials for the office of chairman of the Council of Economic Advisers. I have no doubt in the wisdom of the President in nominating you for an office that is so important to him in his arriving at judgments that affect our entire economy. I know you will serve with great distinction.

The CHAIRMAN. Thank you.

Senator GRAMM.

Senator GRAMM. Dr. Boskin, this flexible freeze stuff, I think I'm beginning to get it. What you're talking about, if I understand—and this is pretty profound—you're talking about Congress setting priorities; is that it?

Mr. BOSKIN. That's correct, sir, yes.

Senator GRAMM. So you're saying that, in essence, you've got the economy growing and generating $85 billion worth of revenues, and $50 billion has to go to meet Gramm-Rudman deficit reduction targets and then there is about a 3 percent growth in spending that can be achieved with the remainder. So if you give a whole lot of that in Social Security or you pay interest on the debt, or if Medicare grows very rapidly and you're not going to try to constrain it, you offset it by controlling spending somewhere else or are actually reducing it somewhere else. Is that it?

Mr. BOSKIN. That's correct. I would say that I think there is a general desire, not just for budget concerns, but for financial well-being and the provision of services for the elderly, not automatically to assume that the inflation rate in the services they buy, such as health service, will be as high as it was in the past.

Senator GRAMM. So it's sort of like saying that we have an emerging need, like the war on drugs for the government or on an individual level it is like the situation where somebody's child turns 18 and is they are going to go off to Stanford or Texas A&M. The family miraculously reorders priorities and increases the expenditure on education by $15,000. They may borrow some of it on a guaranteed student loan, but they spend less in other areas. Is that how this works?

Mr. BOSKIN. Roughly speaking, yes, sir.

Senator GRAMM. Well now I want to ask you a question on the other end. I hear people talking about, and they don't say it, but they're really talking about raising taxes. So I thought in preparation for this hearing I would look back and see what we're already doing in terms of taxes. I don't know if you saw the CBO estimate for next year, but they are estimating that next year the Federal Government is going to take 19.4 percent of GNP in taxes.

Now there are only 3 years in the post-war period where we have topped that, and I think it's important to look at what they are. In 1969, when we had the surcharge on taxes, President Johnson said we would all feel good if we paid more taxes for Vietnam, and then in 1981 when we were in the process of cutting taxes and in 1982 when we were in a recession and GNP was down.

Any other period of time in the post-war period when we have approached 19 percent we've been debating cutting taxes and not raising taxes.

Does it concern you that there is all this contemplation about raising taxes when in fact we have the highest percentage of the economy going in Federal taxes today that we've had, except for these three extraordinary years in the post-war period?

Mr. BOSKIN. Well, I certainly would be concerned about the prospect of a tax increase, but I think with the proper leadership from the President and the Congress that we'll be able to bring the budget deficit under control without a tax increase.

You're quite correct that taxes as a share of Federal taxes and as a share of GNP have been stabilized. I think the notion that they have been cut in the 1980's is actually quite inaccurate. They were projected to grow a lot and we stabilized them, and if you want to call that a cut for projected growth I guess that's a semantic issue.

We also collect a lot of taxes at the State and local level. We're a fiscally Federal Nation. So comparisons to other countries can be misleading on that score.

So I'm concerned that we keep taxes as low as possible and I'm concerned that people not think anywhere, whether that's in Washington or elsewhere in the country, that raising revenue and new taxes are a good idea. I think that there are some people who believe that massive new spending on a variety of programs is highly desirable. I do not share that view, and I think that is a primary reason I am here today.

Senator GRAMM. Is it your professional judgment that, if we read George Bush's lips literally and didn't raise taxes, that we in fact limited the growth of Federal spending to 3 percent, then the economy would have a much higher chance of sustaining the recovery and job creation?

Mr. BOSKIN. I certainly agree with that. There are many other factors like monetary policy that must be considered, but certainly.

Senator GRAMM. The head of the Federal Reserve Board has said that if the Congress controls spending and reduces the deficit and has a tighter monetary policy on government he can have an easier monetary policy on the private sector.

Mr. BOSKIN. That's exactly right.

Senator GRAMM. What he's saying is that he will have to do the work if we don't; is that right?

Mr. BOSKIN. That's exactly right, and in Chairman Greenspan's testimony he said that we need to get the deficit down and, as he put it, we need to do it primarily, preferably exclusively, on the spending side. Those were his words.

Senator GRAMM. Well, let me say, Dr. Boskin, having listened to my colleague, Senator Heinz, that I think an excellent next step in this process, this Gramm-Rudman-Hollings process, would be to move Social Security off the budget and to balance the budget without counting Social Security. We have in fact had a similar period in American history. It was a resumption of the Specie period from 1865 to 1879, and in fact during that period we had the Government running surpluses and worrying about exactly the problems that you were suggesting we might worry about. I'm ready to worry. I want to join these other fellows in worrying.

Senator HEINZ. About good news.

Senator GRAMM. Good news.

Thank you, Mr. Chairman.

The CHAIRMAN. At this point the next in order is Senator Sarbanes, and I'll call on him for questions. We have had Senator Graham and Senator Shelby join us.

Do either of you want to make a brief initial comment?

Senator GRAHAM. I do not have an opening statement, Mr. Chairman.

Senator SHELBY. Mr. Chairman, I have an opening statement I would just like to have included in the record.

The CHAIRMAN. We will do so. We have other committee meetings going on and confirmation hearings as well. So members must come and go.

OPENING STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, first may I commend you for scheduling today's hearing so expeditiously. This country faces several big economic problems and I think it is essential that the administration is fully staffed as soon as possible.

I have looked over Mr. Boskin's credentials and I have enjoyed discussing severalissues with him. I believe he is well qualified for this job and will bring to the Coiuncil of Economic Advisers some fresh ideas.

Dr Boskin, one of the Federal Government's primary concerns this year is how to resolve the thrift crisis. This is going to be very costly problem and it's one that we do not have room for in our deficit-constrained budget.

Treasury Secretary Brady recently suggested a tax on savings or a user fee for deposit insurance, whatever you want to call it, that went over like a lead balloon. What is your reaction to Secretary Brady's idea? Do you believe that a tox of this kind would become a significant disincentive to savings?

We need to encourage personal savings in this country. Yet the realities of the budget limit us from adding tax breaks for savers and president bush's campaing pledge precludes us from taxing consumption. What flexibility do we have to encourage savings, given our present budget situation? During our discussion yesterday, you stressed the importance of financing more of our deficit from Internal rather than external or foreign sources. By incorporation personal savings incentives in the tax code, would the increase in the available pool of domestic savings lower the interest rate to the U.S. Government enough to compensate for the corresponding Drop in revenues?

I look forward to your testimony and to working with you over the next few years.

Thank you.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Dr. Boskin, it struck me that one of your responses to Senator Gramm's question was incomplete. I think the question was what the flexible freeze is all about is the Congress setting priorities, and you said that was correct; is that right?

Mr. BOSKIN. That's part of the answer. Of course, it's the President setting priorities as well.

Senator SARBANES. Thank you very much. The President also must set priorities.

Mr. BOSKIN. That's correct, and he will.

Senator SARBANES. What do you expect the growth of the economy to be in 1989?

Mr. BOSKIN. My best professional judgment is that the growth of the economy in 1989 will be a little over 3 percent after adjusting for inflation.

Senator SARBANES. 3½ percent?

Mr. BOSKIN. Well, we have to be careful here, as you know, Senator Sarbanes. If we measure it on a year-over- year basis I think it will be slightly over 3 percent. If we measure it fourth quarter over fourth quarter, there is particular peculiarity because of the effects of the drought which lowered third and especially fourth quarter GNP the way the Commerce Department does the numbers. So we'll be measuring from an artificially low end of 1988 to 1989, and I think the best estimate of that will be a little more robust, 3⅓ and to 3½ percent. The economy is growing a little more rapidly than that now.

Senator SARBANES. Fourth quarter to fourth quarter you would agree with Sprinkel that it's going to be 3½ percent?

Mr. BOSKIN. Well, let me just say that in all these forecasts there is considerable uncertainty. So I wouldn't want to suggest that by giving you a rough approximation that there is not a range of alternatives around there, but I think fourth quarter over fourth quarter a little over 3 percent is the best guess. It's growing a little more rapidly than that when we exclude the effects of the drought right now.

Senator SARBANES. So you're staying shy of Sprinkel's economic outlook, is that correct, as far as fourth quarter to fourth quarter growth of 3½ percent?

Mr. BOSKIN. No, sir. I'm in the process of evaluating not only those forecasts, but the recent information I've received.

Senator SARBANES. You're not prepared to embrace the economic growth forecast that was made in the Economic Report of the President sent to the Congress in January?

Mr. BOSKIN. For the time being I have accepted it, sir. I think it is reasonable. I am continually examining it and I'm using information on the economy that has occurred since that report was prepared, for example, and I will be continually updating my forecast.

Senator SARBANES. So you're not confident enough of it to in effect go on the line for it here this morning?

Mr. BOSKIN. Well, I'm not sure what you mean by going on the line, Senator. I think it was the best forecast at the time and I think the economy can and is likely to achieve that real growth rate, but I wanted to just say that I'm continually updating my information on the economy, and I think for current purposes that is probably the best forecast.

Senator SARBANES. Now where do you expect interest rates to be in 1989?

Mr. BOSKIN. I expect interest rates to abate some from where they are now. I think they have gone up at the very short end of the market as you know.

Senator SARBANES. 8.3 percent?

Mr. BOSKIN. That's right. They have gone up over 200 basis points since March. I expect that recent actions by the Federal Reserve, which have helped keep long- term interest rates relatively stable, indicating that the message that inflation will not accelerate is getting across, and I believe that we will see a reduction in interest rates both at the short end and the long end of the market because of recent Fed action and particularly upon a deficit reduc-

tion agreement or a deficit reduction package that the Congress votes out when it does so.

Senator SARBANES. What would you project for 1989 would be the 3-month T-bill interest rates?

Mr. BOSKIN. For 1989?

Senator SARBANES. Yes.

Mr. BOSKIN. I believe it will come down substantially from where it is now.

Senator SARBANES. Well now it's at 8.3 percent; is that right?

Mr. BOSKIN. That's right.

Senator SARBANES. Where do you expect it to come to, what do you project for 1989?

Mr. BOSKIN. I expect it to come down substantially, sir. To give you a point estimate would indicate a degree of precision that would presume I could prejudge what the final deficit resolution will be with respect to what the Congress does.

Senator SARBANES. Well, the Economic Report makes such a prediction.

Mr. BOSKIN. That's right, and the prediction is premised on——

Senator SARBANES. 6.3 percent; is that correct?

Mr. BOSKIN. That's the report by the Council.

Senator SARBANES. Do you accept that prediction?

Mr. BOSKIN. I believe it is in the range of possibility and not unreasonable if a serious deficit reduction package is passed and passed early in the year.

Senator SARBANES. Now what was the growth rate in 1988, or what do you estimate it to be? I mean it's still an estimate, but what do you think it will be?

Mr. BOSKIN. It's still an estimate, but the growth rate in 1988, exclusive of the drought, will be somewhat over 3 percent. Taking account of the drought, which lowered it, it will be slightly under 3 percent.

Senator SARBANES. 2.6 percent?

Mr. BOSKIN. In the high 2 percent, that's correct. In 1987 it was 5 percent.

Senator SARBANES. My time is running out and that's why I'm trying to move along here. Now the question I want to put to you is given what Greenspan said the other day, how do you reconcile a jump in the growth rate from 2.6 percent to 3.5 percent, 2.6 percent for 1988 and you're projecting 3.5 percent for 1989? How do you reconcile that kind of jump in the growth rate with a drop in interest rates from 8.3 percent to 6.3 percent?

Mr. BOSKIN. Sir, let me first point out that this was a projection of the previous Council and the previous administration and it's not to be construed yet as an official forecast for the Bush Administration.

Let me also say that the 2.6 percent to 3.5, percent a large part of that difference is due to the drought. If we purge those numbers of the drought, we are expecting the growth rate to come down a little bit.

Senator SARBANES. Well, let me say if your response is that you don't accept the figures, then I take that as a response because then you're not in this box, and if that's your response, in other words, you don't accept the growth figures or the interest rate pro-

jections, then that resolves the dilemma. I don't see though how one can explain it otherwise, how you're going to go from 2.6 percent to 3.5 percent growth and at the same time project that you're going to bring interest rates down from 8.8 percent to 6.3 percent.

If you don't take those figures, then you'll have to work up a different set of figures, and I assume they will have a greater internal consistency. I accept that answer if that is your answer.

Mr. BOSKIN. Well, the answer is that preliminarily I have accepted and am working on that and I'm continually revising and updating and there will be additional figures later on. There is a formal process, as you know, sir, at the mid-session review and there may be some before that.

But let me just say that the 2.6 percent to 3.5 percent can be very confusing, and I want to make sure that it's very clear that when we do the figures removing the decrease in real GNP growth in 1988 because of the drought and the expected rebound in 1989 because of the drought, actually the forecast is for a slight slowing between 1988 and 1989 and not for speeding up.

Senator SARBANES. Thank you.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman.

Dr. Boskin, I would like to go back to the effect of our low rate of savings in this country. I know that has concerned you in previous writings, and I think it concerns everyone. Do you have any suggestions?

Mr. BOSKIN. Yes, ma'am. Senator, I believe the singlemost important thing we can do to raise the rate of saving in the United States, our national saving rate, the sum of what households and businesses and governmental units save is to reduce the Federal Government budget deficit. That is the surest, simplest, simplest conceptually, and I realize that's difficult politically, and largest in terms of its effect on the saving rate policy that we could follow, and as a corollary to the question, Senator, that we need to do that in a way that does not impinge on private saving. That is the single most important thing we can do.

Dealing with personal saving is a somewhat more complicated issue. We have had some limited success with IRA's, but that is somewhat controversial as to how much extra saving they have generated. I think they were partially successful, but we limited them as part of a grander compromise in 1986. Were there other alternatives available perhaps not limiting IRA's it might have led to a small additional amount of private saving, but that is not something we can depend upon to be large, and it's not something we can depend upon to be known with certainty.

There are a variety of things that give me a little bit of optimism as we look go the future. Demographic changes were partly responsible for the decline in saving in the United States, and as the baby-boom generation passes their peak consumption years and moves to ages where people traditionally save more, that should help a little.

One concern I have had in my own research documented both in the United States and also in the higher saving economy of Japan is that the baby-boom generation has been saving less at each age

than its parents 'generation did, and I have been trying to understand why that has occurred.

I personally believe that the saving rate will gradually—it will certainly fluctuate, but I believe it will gradually improve. It is about 1 percentage point higher now at 4.2 percent than it was last year of disposable income. It would be desirable for it to rise further.

I think some steps that were taken in tax reform, such as limiting deductibility of interest on consumer debt, which we are gradually phasing in, which means that people will be borrowing a little less, which is kind of like draining savings, it's a negative saving, is desirable.

But let me repeat once again that we very much need to focus on our long-term national saving and investment, investment both private and public I might add, on research and development, on long-run economic growth as a source of the well-spring of our international competitiveness and the rise in standard of living we can provide to our citizens, and it seems to me the best and most important place as far as reducing the budget deficit.

Senator KASSEBAUM. Well, I certainly think that is a key component, but you separate the public and the private, and I think that's important because it's private in many ways that I think we just don't realize what an enormous drain this is I think in productivity, and the flatness of our productivity over the last 10 or 15 years. Do you see that has a key component to what I think is really very much one of our major issues today?

Mr. BOSKIN. I certainly do, Senator. I believe if we had a higher saving rate, other things being equal, like not having a higher deficit as a result, if we had a higher saving rate on average on a span of years, I believe that would increase our investment, increase our productivity and increase the standards of living of Americans and lead to a greater international competitiveness. I think that lower interest rates make the cost of capital lower for our businesses to compete internationally and so on.

Senator KASSEBAUM. Now Senator Gramm pointed out that actually the percentage of GNP in our taxes has increased rather than decreased at the levels that I think many have assumed, and certainly when we had our major tax reduction, which was the Roth/Kemp approach in many ways in 1981–82, it was hoped that with that people would save more, and that has not occurred.

Do you believe that further reductions such as Candidate George Bush suggested on the capital gains would enhance savings?

Mr. BOSKIN. I do believe that a carefully designed reduction in the capital gains tax, or providing some sort of differential, could indeed lead to increased saving and investment and entrepreneurship and risk-taking in our economy and that could be desirable.

I also believe with respect to the first part of your comment that if we look at the decline in the overall national saving rate, a lot of attention focuses on the budget deficit, as it rightly should. That has come down a couple of percentage points as a share of GNP relative to several years ago and it's projected by everybody, although at different rates, depending on who the forecaster is, to continue to decline as a share of GNP, and that much of the decline in our national saving has been a decline in personal saving.

I think one reason for it was that we had a tremendous increase in the stock market in the 1980's. We all have the stock market decline of late 1987 in mind, but the Dow Jones Industrial Average was 770 in 1982 and it's now 2200 plus. A lot of people have money in their pension funds and we saw a tremendous increase in the value of that, and that increase in household net worth is one reason people have been saving less discretionarily.

Senator KASSEBAUM. Well, I've lost my time, but I guess you believe the savings would balance out the revenue loss, if indeed we went to capital gains tax reduction?

Mr. BOSKIN. I believe savings would increase and I believe a properly crafted capital gains proposal could be crafted which would not lose revenue and perhaps gain a little revenue.

Senator KASSEBAUM. Thank you.

The CHAIRMAN. Thank you, Senator Kassebaum.

I think you have raised a very interesting area of concern that I think is widely shared, and I think on the foundation of the issues you've raised I'm hoping that in the period ahead we can take a closer and closer look at this question of how we induce greater saving and investment in the economy. I'm hopeful that that's one of the areas we can get into in this committee.

Senator SHELBY.

Senator SHELBY. Thank you, Mr. Chairman.

Dr. Boskin, I certainly enjoyed meeting you yesterday in my office, and I enjoyed our discussion touching on a number of topics of economics.

Mr. BOSKIN. As did I, sir.

Senator SHELBY. In our conversation on the Hill yesterday you brought out that this is the 1980's, nearly the 1990's we're dealing with, not the 1950's or the 1960's. There are dissimilarities between our economic situation now and then.

Of course, we have compounded our problems economically, by not being as competitive as we should be in the world market. We've got a persistent trade deficit problem. We thought we would grow out of it, but we haven't.

Our status today as a debtor nation, the largest debtor in the world is certainly quite different from our creditor status in 1950's–1960's.

What are some of the other differences economically speaking between what you view as the 1950's and 1960's view of economics and what we are coming up in the 1990's or around the turn of the century? Is that profound?

Mr. BOSKIN. Well, Senator, there are several profound ones. There has been, as Senator Heinz referred to earlier and a couple of other members of the committee did, a dramatic change in the demographic structure which forms the basis of our economy and our society.

We have had tremendous changes in the average size of families, life expectancy has increased, we had the baby-boom generation and the so-called baby-bust. Those are working their way through the population. At first they led to a big expansion in the school system when they were young and we'll deal with their retirement early in the next century.

The tremendous internationalization of economic activity, which the United States did much to lead, in the Kennedy and Tokyo rounds of tariff reduction and hopefully we'll continue to lead in the GATT, in the Uruguay round of the GATT to lead to freer and fairer trade and liberalization in various areas that provides access to markets for our products as well is a tremendous difference.

For example, we sometimes hear people become very concerned. Senator Gramm was concerned that people got worried about good news. That capacity utilization, which Chairman Greenspan mentioned yesterday in his testimony to the House Banking Committee, is not a terribly well defined and accurate measure, but some people think since it's getting close to levels which were associated, or occurred simultaneously, with some increase in inflation back in the 1960's and 1970's, people worry about that, but now we have much more of a global economy and that will lead to, as he indicated in his testimony, less price pressure for the same degree of capacity utilization.

We have a much higher fraction of our labor force working in the market. We have tremendous changes in the structure of American families. We have had a tremendous change in the role of government, much of it for the better, but not all. We have had tremendous changes in our tax system, we had many in the 1980's, and we've had tremendous swings in inflation. We had the big increase in the late 1970's and we've had a reduction in inflation down to the 4.5 percent range.

So those are some of the important ones, but I would focus on internationalization, the demographics as some of the really key items, and of course the tremendous changes in technology and communications and information and so on.

Senator SHELBY. Dr. Boskin, what does it mean to you from the standpoint of an economist when short-term rates are exceeding in some cases long-term interest rates? What does that mean to you?

Mr. BOSKIN. Well, that so-called inverted yield curve suggests a few things, that there is a tightness at the short end of the market, and that is leading people to have to pay higher rates of return.

Senator SHELBY. Is this caused from the Fed tightening up on the money supply?

Mr. BOSKIN. Well, the Fed certainly has been operating at the short end of the market. It also suggests though that since long rates have not risen as short rates have, they have risen very little, that a signal is getting out that we are not going to tolerate an acceleration of inflation in the long term.

If the whole yield structure or all interest rates had gone up together, that would have suggested that people were not convinced that the administration and the Congress and the Fed would do the right thing and keep inflation under control.

Senator SHELBY. Has it meant to a lot of economists in the past that a downturn is imminent in the economy, a recession?

Mr. BOSKIN. It has as have many other signals sometime preceded a slowdown, but it has not always done so.

Senator SHELBY. It depends on the economist's interpretation of it?

Mr. BOSKIN. Well, it depends on a lot of other events. It's only one signal, sir, and it's certainly one that one ought to be con-

cerned about, but it depends on a whole bunch of other things, and you can't just isolate one factor. But you are certainly correct that at times in the past it has preceded a slowdown in the economy.

Senator SHELBY. If you had one concern about the economy, would it be inflation, would it be growth or what?

Mr. BOSKIN. It would be the combination of the two. We need to continue noninflationary growth. I think Chairman Greenspan was correct in saying that we can't get ourselves into the situation we did in the 1970's, and I blame no one in particular for that. There is enough blame to go around across all members of our society.

If we let inflation get much higher, the eventual pain of disinflating the economy will be quite severe and we should not allow that.

My concern is that we through serious and hopefully relatively rapid reduction and commitment to reduction in the budget deficit will provide the Federal Reserve the elbow room to provide the liquidity to allow those interest rates to fall to promote the growth in our economy that we so badly need to provide increasing income and employment to Americans.

Senator SHELBY. What should be the No. 1 economic priority of this administration?

Mr. BOSKIN. I would say of the country it would be to reduce the budget deficit.

Senator SHELBY. Immediately?

Mr. BOSKIN. Well, let me just say what I mean. Immediately, I mean we should do it quickly, but we shouldn't sort of take an accountant's notion of it. We should do it gradually over several years as is currently contemplated by Gramm-Rudman. I think if we tried to reduce it by $150 billion all at once that would make the Fed's job enormously difficult and might well slow the economy.

Senator SHELBY. But we've got to make the profound step, haven't we?

Mr. BOSKIN. I think we have to send a signal to the financial markets, the Federal Reserve and to the world economy that we are moving to reduce our budget deficit and we're moving strongly.

Senator SHELBY. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Shelby.

Senator ROTH.

Senator ROTH. I have one concern with what you've said because it seems to me that as important as reducing the deficit is, that it's really part of a larger and more serious problem, and that's the problem of becoming competitive in this emerging global economy.

It seems to me important that we keep our eye on that goal or objective because to lower the deficit will not necessary accomplish all that needs to be done in the rest of the 1980's and the 1990's. Would you agree with that?

Mr. BOSKIN. Reduction of the budget deficit is a means to an end of which the increased investment in productivity and competitiveness and rising standard of living is the goal.

Senator ROTH. Now part of that problem, as you said in answer to Senator Kassebaum, is the question of saving, and one of my concerns in this area is that there seems to be a tendency, in

Washington, and among economists generally to minimize the role that tax incentives can have on individual savings.

Now, for example, I think there was a study in 1987 by the National Bureau of Economics Research which published a paper saying that IRAs increased U.S. saving very substantially. Now what bothers me about the conventional wisdom is that if we don't have a deduction for interest, everybody agrees that people are going to borrow less and it will have some impact on spending.

But I don't know why the reverse of the coin isn't true. I can tell, as I mentioned earlier, coming down here a conductor on the train said to me that he was unhappy about the article on taxing savings in banks, and I think in a sense going back to Darman, if it quacks like a duck, looks like a duck and so forth, it is a duck. But, anyway, he said that he has not put anything into an IRA for the last 2 years.

I can tell you that time and again last fall in the campaign people said the same thing to me, and these were not wealthy people. These were teachers, working people, blue collar, saying that the IRA's had been an incentive for them to save.

Would you care to comment?

Mr. BOSKIN. Yes, sir. I do believe, as I indicated earlier, that I think IRA's were partially successful on stimulating saving. I think some people ask why didn't the overall saving rate go up, and they therefore conclude since it did not, it actually fell, that IRA's were not successful. I think that's the wrong way to phrase the question. The question is what would the saving rate have been had we not had IRAs, and I think the answer is it would have been a little lower, as the study referred to suggests.

I think the modest positive impact of IRAs was more than offset by a whole bunch of other things. For example, the big increase in the stock market created a situation where defined benefit pension plans that were not fully funded became fully funded, and the actuaries told the firms that they didn't have to contribute any more, and the slower contributions to defined benefit pension plans, which are part of saving, more than offset the positive contributions of IRA's. Now you can't blame IRA's for that, but I think if we did the accounting carefully, we would conclude that IRAs were partially successful.

Senator ROTH. Let me ask you this. In a very real sense we're talking about changing the customs or the practices of the American people. We have been a consumer country. People like to spend and borrow to spend. What we're talking about is trying to change and make them more saving oriented.

Now by merely introducing IRA's or a tax incentive, can we expect that kind of practice to change overnight or isn't consistency over the long run part of the picture?

Let me point out I think in the case of Canada IRA- like accounts have been expanded since the 1970's, and since then the Canadian private savings rate has increased relative to the United States.

So I would hope and urge that we take a hard look at IRA's or some kind of similar tax incentives and would ask that you do so.

Do you have any thoughts as to how we might use tax for that purpose?

Mr. BOSKIN. Well, you're certainly correct, Senator, that the registered retirement accounts in Canada appear to be one of the reasons why the Canadian saving rate has gone up a little bit and has not fallen like the U.S. saving rate, despite a lot of other similarities in our countries.

IRA-like tax deferred savings plans in other countries are generally credited with helping them to have a higher saving rate. The Japanese are making some small changes in theirs with their postal savings accounts and they are credited as being one of the reasons for the high Japanese saving rate.

So I think that in the future we can afford to examine or deal with the possible risk on losing some revenue, and I think we have to be very judicious about anything that might lose revenue in the short term. But I certainly agree that IRAs were, and they still are for some people, but not for the entire population, an incentive to save and were desirable, and I think that we will be examining every avenue we can to try to deal with this problem you indicated of the consumption oriented society versus a saving, investment, future growth, R&D, productivity, international competitiveness organized society.

Let me point out for those mostly behind me I would gather who aren't aware of it, consumption is a huge multiple of saving. For a typical family that is saving a few percent of its income and spending the rest, it would take only a tiny reduction in the rate of growth of consumption. You wouldn't even have to cut it, but just slow it a little bit to lead to a pretty substantial percentage increase in savings.

So I think that idea is an important one, but I again remind you that we have to be very careful about anything that would lose revenue.

Senator ROTH. Mr. Chairman, if I could just ask one final question on this.

You mentioned that the IRA type account has been very successful as a means of providing for old age, might not this be a device promoting savings which helps the national economy but at the same time also in meeting family needs if you permit them to save for long-term care or you let them save for the purpose of sending their children to college or to meet some of the needs that we find today in this country?

Mr. BOSKIN That is an important and interesting possibility that I've given a little bit of thought to and I very much hope to be able to work with you, Senator Roth on that. Candidate Bush, then Candidate Bush indicated some predilection to some things of this sort when he indicated he would like to allow people to roll over some of their IRA's into long-term care and things of that sort. So there is some consideration that has been given to it in the past and some awareness of the immense importance of this issue and it is one of the avenues we will explore.

Senator ROTH. Thank you, Mr. Chairman.

The CHAIRMAN. Now I want to go and and try to lace together a couple of points that have been developed earlier in the hearing.

If you subtract from the deficit, from the operational deficit that we ran this year and are projected to run, if you subtract out the trust fund surpluses, the Social Security Trust Fund surplus being

the largest, but there are others as well, from the calculation of the deficit, isn't the deficit running at about $250 billion?

Mr. BOSKIN. The non-Social Security deficit is running well over $200 billion and there is a Social Security surplus that matches that. You have to be a little careful in making these calculations, particularly as we go out a few years and we focus on 1993 or 1994, Senator, because the Social Security fund becomes large enough that it gets a lot of interest, and that's just sort of a transfer from one component of the Government to the other.

The CHAIRMAN. Well, I'll get into that in a minute, but if you take the other trust funds, the highway trust fund's surplus or other trust funds 'surpluses that are there, if you take them all our true operating deficit today is very close to $250 billion. Now do you not agree with that?

Mr. BOSKIN. No. I agree that the nontrust fund, the general fund deficit would be on that order of magnitude.

The CHAIRMAN. Well, that's the true operating deficit, as I see it, to the Government because we're taking and we're lifting these reserves out of the trust funds that are there for other purposes and we are applying them in this accounting trick, if you will, to make the deficit look smaller than it is, and that really came about when we passed Gramm-Rudman-Hollings in 1985. I think the reason was we weren't having any luck bringing the deficits down. The deficits were very large and they were growing above $200 billion.

So a discipline was invented and the administration at that time was obviously was a party to it. So we have created a discipline that makes the deficit actually look smaller than it is. It makes it look like it's $150 billion, but if we take out these surpluses, which we are I think improperly posting against the real cost of government, the deficit jumps up to $250 billion.

I think it's a very significant fact, but related to that is something that is very troubling to me, and I don't think the public has figured out yet, and I think we owe them the truth on this issue, and that is that when we borrow these trust fund surpluses, part of the revenue that Senator Gramm spoke about before that he attributes to just the natural flow of revenue into the Government, a very large part of it is the Social Security surplus add- on. It's not tax revenues coming in from income taxes, from corporations or individuals. It's Social Security build-up there for a purpose to be applied in the future against benefit claims.

We are borrowing that money, the Government is, we're spending it on the day-to-day operations of government and the money is gone, and in the future when the Government has to pay back to the Social Security Trust Fund the money that it has borrowed, who is going to provide that money? Aren't taxpayers?

Mr. BOSKIN. Well, it depends on what the future Social Security policy is, sir. If nothing else changed in the demography or the benefits, et cetera, in the future there will be higher taxes to pay any given level of benefits if there is less of a surplus to draw down.

The CHAIRMAN. But the Federal Government, the operating side of the Government is going to owe the trust funds the money that it has borrowed, and at some point that has to be paid back so that money is in the trust fund to pay future Social Security benefits.

If the Government then at that point, the general government has to raise the money to pay back to Social Security, who will the Government raise that money from? Won't they raise it from the taxpayers of the country, the taxpaying base of the country?

Mr. BOSKIN. Well, it would depend on a variety of things, but as a rough characterization, that's right. There may be a reason to borrow it at that stage if Social Security is being drawn down rapidly or some other things are going on macro-economically.

I think it's important also, sir, to distinguish the macro-economic impact of the deficit, which is more properly measured by the unified deficit from the issue you're raising, which is certainly a valid one.

The CHAIRMAN. Well, maybe. I meant the equity issue now in terms of the individual person who is paying the money in today into Social Security for a dedicated purpose. They want the money protected and they want it there when they need to draw that for their benefit stream in the future. And in fact what's happening is we are borrowing the money partly because we need the accounting trick to make Gramm-Rudman-Hollings look like it's working, when in fact it isn't, and we are spending the money, and in the future we're going to have to go back to those same taxpayers who today are paying into the Social Security fund, and ask them somehow or another to in effect pay a second time as taxpayers to generate the money to replace the money that they put in in the first instance in the Social Security fund, but which was borrowed and spent.

Now I haven't heard anybody yet be honest and direct about explaining that relationship to people, but that's what is going on here. It's not as if we are investing those resources that we are borrowing from Social Security in an income-producing asset as such where in effect we were going to have a stream of future earnings as we normally think about putting money aside to generate a future income.

We are spending the money, and we are spending it in a sense to maintain the fiction of reaching the Gramm-Rudman- Hollings targets, which we're not doing, and which you just acknowledged yourself, take out of the trust fund surpluses and the deficit is up to about $250 billion.

You folks are making a fresh start here. You are a new administration and you're coming to town as a new player. I think it's time that we try to move to honest accounting.

Now a few years ago we went to dishonest accounting in the savings and loan system, and now we've got a $100 billion hole to fill in terms of trying to solve that problem.

It appears to me that we're doing the same thing with respect to the way we account for the financial activities of the Federal Government, and the fact that we say that in 1992 we're going to have an answer, i.e., a balanced budget or at least meet the Gramm-Rudman-Hollings targets, and it sounds to me like the same old song. In other words, it's always off in the future.

Ronald Reagan was going to do it when he came to town. He spent 8 years, he just left town and we're not within rifle shot of it, and we're saying, well, we've got to plan that we are going to be there 4 years from now, but it's all predicated on taking and emp-

tying the surpluses out of these trust funds, and I really don't think that is the right strategy. I don't think it's fair to people and I don't even think it's honest in terms of really letting people understand what's going on here.

Mr. BOSKIN. Well, Senator, I certainly agree that we want to present people with the information not only on the unified budget deficit, but by separating the trust fund surplus and the general account deficit. I think that's important and I think we need to provide people with clear comprehensive information and explain it, and I will certainly attempt to do that in my role as the Chairman of the Council of Economic Advisers.

You mentioned a variety of other accounting issues, and this is only one. The Federal Government doesn't keep a separate capital account, and I won't get into details on a variety of others.

I would hope that one of the things that we can do working together would be to provide more useful and usable information. Again, though, I want to come back to this issue. You raised the issue of whether including the Social Security surplus in the overall unified budget deficit for Gramm-Rudman-Hollings purposes was desirable or not, and I think there are a variety of issues involved there besides the equity one you mentioned.

I think for the overall macro-economic stability it's important that we present the unified budget because that's what generates the net borrowing needs of the Government and so on.

You raised some genuinely important issues, and I certainly hope we can clarify them.

The CHAIRMAN. Thank you.

Senator PRESSLER.

Senator PRESSLER. Thank you Mr. Chairman, Dr. Boskin, very much.

I want to say it was good visiting with you the other day, and I think you are one of our most knowledgeable economists.

I have listened with interest and you believe we will have about a 3 percent growth rate. It has also been discussed here that certain elements, outlays in the budget will increase by as much as 11 percent, such as Medicare. There are many costly programs that President Bush actually proposed in his campaign, and we have not yet seen his budget.

I'm not arguing here, but if there are to be no new taxes, this means that there is going to have to be some massive cuts in the Federal budget, or at least I believe that would be interpreted that way.

As a professional economist, what are three or four areas that there could be major cuts in the Federal budget that you would recommend and by what amounts?

Mr. BOSKIN. Senator, I am not yet a member of the administration and no such budget decisions are made or have been made by the President.

Certainly if one was looking for large savings, they would have to come from areas where a lot of money is being spent, and we all know what those areas are.

Let me just say that, and I don't want to get into a semantic argument, but cuts have to be defined as relative to what, and we have been trying to explain that the flexible freeze and the general

notion of what we're going to be doing is slowing the growth of spending. Now you might want to call that a cut because it's a cut from a much more rapid growth.

Senator PRESSLER. All right. Yes, I understand that. Then in what areas would you as a professional economist and in your view should the rates of growth be cut the most severely?

Mr. BOSKIN. Well, as a professional economist I would make three statements.

One is that the most important thing is to reduce the budget deficit in a way that does not impair either private saving or productive public investment.

Second, that within the composition of spending that public investment on research and development, tangible capital and education and those sort of things—the future oriented kinds of things we were talking about earlier and several of the Senators have mentioned are high priority and—as Senator Riegle mentioned with respect to our accounting, we should draw some kind of at least conceptual distinction between those and general operating current expenses.

With respect to specific areas, I think that is something that is not general expertise of an economist to suggest what the social priorities are. I think that is more appropriately the role of the President and the Congress to decide that.

Senator PRESSLER. You are one of the leading economists in the United States. What I'm trying to get to are three or four areas that you would feel would be most appropriate, and you've defined things that shouldn't be cut, three or four areas that as a professional economist appearing before this committee you would select, whether you call them cuts in the rate of growth or cuts in spending or however you want to say it, what would be three or four areas you would suggest?

Mr. BOSKIN. Let me just repeat, sir, if I am confirmed by the Senate, I do not believe it would be my role as Chairman of the Council of Economic Advisers to get into the specific areas which involve social priorities and things of that sort.

Let me just say that in terms of the things I would look at, several of the Senators have mentioned already that there are some areas where the rate of inflation has been much higher than the rate of inflation in general, and one would hope, for example, that we could look to some of those areas to try to slow the rate of inflation in those areas, not just to save funds for the budget, but also to relieve paying those higher prices from the cost thereof.

I'm not trying to avoid the question. I really don't believe that it is my role as a professional economist giving advice on the importance of reducing the deficit and the likely effects on the economy to delve in other than into these distinctions between investment and consumption and so on.

Senator PRESSLER. Yes, but I'm just trying to get a feel for you as an economist and as a person.

Mr. BOSKIN. As a person I would hope very much that we could do what we can to preserve those payments that go to poor people.

Senator PRESSLER. You want to preserve those, yes, I know, but I want to know what you want to cut.

Mr. BOSKIN. Well, again, I think my views as a private citizen I try not to confuse my professional judgment as an economist. The issue is to reduce the budget deficit.

Senator PRESSLER. But you've said here this morning the biggest problem we have is to reduce the budget deficit. I'm trying to get a feel for one area. Can you name one area that you would suggest as a reduction?

Mr. BOSKIN. Well, there certainly have been projected large defense increases. President Reagan proposed very large defense increases, and I think that it would be desirable to examine whether those are really necessary in defense being so large. A slightly slower rate of growth of defense or a flattening of defense, if that is decided by President Bush as what is desirable, certainly could save a lot of money over time.

But, again, setting these priorities is the President's job from the executive branch and is the Congress 'job.

Senator PRESSLER. That is correct, but I'm trying to get a feel of what you think. Now defense is one. What are some other areas, and how much do you think we could save in defense in the first year?

Mr. BOSKIN. Well, again, sir, it would depend on what the priorities were and what was decided. I think you can take the defense budget, which is roughly in round numbers $300 billion, and you could decide, whatever growth rate you applied to it or however much slower growth rate you apply to it roughly speaking, and multiply that difference times $300 billion. Now it's a little more tricky for defense because that applies to budget authority and you have to get the outlay rate and all that sort of stuff. So you wouldn't quite save that in the first year. It would be a couple of years later.

Senator PRESSLER. So what besides defense?

Mr. BOSKIN. Well, as I have indicated, as most Americans, I am concerned about the tremendous increase in the cost in the medical area, in inflation in the medical area, and I would hope that we would be able to work with the Congress, that the Secretary of Health and Human Services and the Budget Director and the Congress could work together to try to come up with additional reforms above and beyond those that have been enacted in the last several Congresses to try to slow the pace of inflation without cutting services to the people involved.

Those are very large expenditures and if we can slow that growth of inflation, we ought to be able to have less spending on those areas than we would if we did not slow the increase in prices.

Senator PRESSLER. What about seeking some revenue from ending some of the deductions in the corporate takeover area for some of the largest takeovers, would that be a source of revenue that would not hurt productivity?

Mr. BOSKIN. Well, I think we have to be very cautious there, sir. Remember that the cost of capital to American business is substantially higher than that to foreign businesses as measured by everyone from Larry Summers to Martin Feldstein, and many other economists and business persons.

We wouldn't want to do anything that would raise the cost of capital to American business and therefore to provide the plant

and equipment and investment in productivity that would help American workers compete internationally. So I think we've got to be very cautious in that regard about limits on interest deductibility.

I would be concerned that we would inadvertently raise the cost of capital to American business, and that would do more harm to our competitiveness than good.

Senator PRESSLER. I have a pink slip that says "Senator, your time has expired."

The CHAIRMAN. But only after excellent questions I might say.

Senator PRESSLER. Thank you.

The CHAIRMAN. Thank you, Senator Pressler.

Senator SASSER.

Senator SASSER. Thank you, Mr. Chairman.

Dr. Boskin, you responded a moment ago I think to one of my colleagues on the question of reducing the deficit, and you indicated that Dr. Greenspan, as I understood you, felt that we should reduce the deficit exclusively on the spending side.

Mr. BOSKIN. No, sir. I said primarily, preferably, exclusively, and I think that is an exact quote.

Senator SASSER. Right. Well, I might just say to you that that is not precisely what Dr. Greenspan said to the National Economic Council the other day. He indicated in response to a direct question as to whether or not we should reduce the deficit with revenues, he said, I don't care how it's reduced. We just need to reduce it, which I thought was a rather stark departure from some of his previous statements before this committee before becoming the head of the Federal Reserve. In other words, it appeared to me that Dr. Greenspan is saying reduce the deficit period.

Mr. BOSKIN. Well, sir, I have before me, and I received a copy and studied it in great detail, the prepared statement of Chairman Greenspan before the Committee on Banking, Finance and Urban Affairs of the House on January 24, and what I said was an exact quote of what he said. Now I don't know how to reconcile that with what he may or may not have said earlier, but I'm quoting this specific document, and I apologize if there is some confusion, sir.

Senator SASSER. Well, perhaps there is. I'm just saying that he said something else on another day. I don't want to get into a battle of documents, but I got a transcript of his testimony because, frankly, I was surprised to hear him say that.

So that we don't become victims of our own propaganda around here, a myth is being propagated that we are at an all time high level with regard to taxation of the American people at the present time and we've heard that myth articulated here this morning.

I was just looking here at the publication of the Congressional Budget Office and their historical tables with regard to taxation as a percent of gross national product. And I looked down here in 1988 and the American people are being taxed at the rate of 19 percent of GNP. You look at the tax rate of 1980 and it's 19.4 percent of GNP and a decade before in 1970 it's 19.5 percent of GNP. So if you look at it as a percent of GNP, the taxation rates have been, oh, fairly stable over the past 20 or 30 years; isn't that correct, Dr. Boskin?

Mr. BOSKIN. Well, Senator, you certainly point to some years when they have been as high as they are now, but I think if we compared the little over 19 percent that we're at now to say the average for the 1970's, we are a little higher. There is no pejorative content to that, and there may be very good reasons for us to be higher now than we were then, but I think the notion that we are paying lower taxes now than we were then is certainly misleading.

Senator SASSER. Well, would you say it's equally misleading to say we are paying taxes at an all time high rate at the present time?

Mr. BOSKIN. Well, there certainly have been years when we've paid taxes at this rate. I think if you took the current rate and compared it to longer term averages, it is higher. Now again we have to decide are we getting what we want for those taxes and is it desirable. You have to evaluate the whole spending package to say whether that is desirable.

You are quite correct, sir, that there have been some years. For example, 1980, was the last year prior to the beginning of those tax cuts, and there was very high inflation rate in that year, and there is some dispute over how to measure it, it was roughly 12 percent, and a lot of people were being driven in to high tax brackets inadvertently with pay increases that barely kept pace with inflation.

Senator SASSER. In 1969 it was 20.1 percent of GNP, and that came at a time when President Johnson under pressure from the Congress imposed a surtax because Sam Rayburn and the majority leader of the Senate went over and told him that you can't have guns and butter, that we've got to pay for this war in Vietnam. They imposed a surtax, and 1969, if memory serves me correctly, that's the last time we had a budget surplus.

Mr. BOSKIN. Well, it's certainly correct, sir, that the economy was robust then and we did have what is sometimes called, with all due respect to the late President, the Johnson surcharge, and maybe we should call it the President Johnson surcharge of 10 percent on income.

Senator SASSER. But, in any case, he wasn't running budget deficits and taxes weren't 20.1 percent of GNP, which is 1.1 percent higher than they are at least in 1988 according to the Congressional Budget Office.

Now when we get into the business of percent of GNP with regard to taxation, when you back Social Security out of these percent of GNP figures with regard to taxation, it's very illuminating.

In 1989 on-budget revenues constitute 13.8 percent of GNP. That's when you take all revenues, on-budget revenues and back out Social Security, and we find that in only 2 years since the Second World War as a percent of GNP have on-budget revenues been higher.

So what I'm driving at, Dr. Boskin, is the increase in tax burden that is being referred to is being carried by Social Security while income taxes or the tax burden carried by income taxes is shrinking; isn't that correct?

Mr. BOSKIN. It's certainly correct that the composition of the revenue has changed, sir. You're accurate in that.

Let me also indicate that Social Security, as Senator Riegle has indicated and Senator Heinz has indicated, until 1983 was run on a

more or less pay-as-you-go basis and by far the largest growth on the outlay side was for Social Security and, as I indicated earlier, that was the primary reason we were able to reduce the incidence of poverty among the elderly. So there was a big increase in Social Security taxes, but also a big increase in Social Security outlays roughly matched it.

Senator SASSER. Another point, and I know my time is up, Mr. Chairman, and I'll stop here, but my point is this, that even though the tax burden has remained relatively constant over the past 20 or 30 years, what we are seeing is that a greater portion of that tax burden is being carried by the Social Security tax, which is a payroll tax and which in and of itself is regressive; isn't that correct?

Mr. BOSKIN. Well, Senator, I would characterize it similarly, but not identically. Certainly taxes are only a little higher today than their historical average. They are not grossly higher if we go back to the 1970's. We're about 1 percentage point or a little more than that higher than the average during that period.

Certainly the composition, you correctly pointed out, has changed both on the tax side and on the benefit side. Let me say that if we took Social Security as a whole, it is probably the most progressive component of the Federal budget.

If we take not only the taxes, which you are quite correct are levied on payrolls up to a ceiling with only the earned income credit applied to them, and compare them to the very progressive benefit formula and the fact that Social Security provides this income to the retirees who not only typically have reduced income relative to their working years, but because of economic growth are not as well off as their children and grandchildren on average, then overall Social Security is quite progressive.

Senator SASSER. Well, that's a new theory. I haven't heard that one before and I'll have to think about that a minute.

Thank you, Dr. Boskin.

The CHAIRMAN. Senator Sasser, let me just make a comment before yielding to Senator Heinz, and that is that I think that shifting of the proportion of revenue coming into the Government that you put your finger on explains why the Government has had to go over and lift the surpluses that are building up out of the Social Security trust fund and the other trust funds and bring them back over and pay the daily operating bills of the Government.

The problem is that the rest of the tax base has been shaved down to the point where we are really having to take and spend the Social Security reserves.

I want to say when people figure out that they are going to pay twice, they're paying into Social Security today to provide for the future, the money is being borrowed and brought over here and spent for something else, and eventually they are going to be asked to pay that bill. So in effect they are going to be asked to pay for their Social Security twice and not once, and that's what is going on today.

And the Gramm-Rudman-Hollings scheme, which is an inherently dishonest formula, in my view, masks that fact, and it's the thing that Senator Heinz began the discussion on today, not to attribute my comments to him, but nevertheless that's the problem

that we face and which you inherit on your first operational day in the saddle here.

Senator HEINZ.

Senator HEINZ. Senator Riegle, I like your phrase, "pay for Social Security not once but twice".

Yesterday I spoke for the 5 allotted minutes on this subject and introduced a bill to do something about it, as did Senator Moynihan today. I will have to go and revise and extend my remarks to include some of your excellent rhetoric.

I want to change subjects briefly. As you may have noticed, the FSLIC is a hot topic. I was looking over Senator Riegle's tentative hearing schedule, and this may be a temporary oversight, but I note that we not only have 14 days of hearings, but as yet you're name or position does not appear on the list. I'm sure Senator Riegle can remedy this if it is absolutely necessary.

My question is on the proposal that was floated yesterday calling for a .3 percent tax on savings that was generally received coolly. Indeed, someone asked me if I could detect any motivation for that particular proposal, and the only reaction I had was it was to make any other proposals look better.

I am biased against that proposal because it strikes me as a tax on savings. It may be difficult to find a way to avoid taxing savings, but would you agree that if we can, we should avoid taxing savings and fashion some other means of coming up with whatever the Federal Government's necessary contribution to the FSLIC will be?

Mr. BOSKIN. Let me just give a three-part answer to that, sir.

Senator HEINZ. Is this the same three-part answer that you gave to Senator Pressler?

Mr. BOSKIN. No. I just want to give a preamble, which is that, first of all, I personally have been only tangentially involved in discussions in a very general basis with the Treasury, and to the best of my knowledge, the Treasury has not decided on the final list of proposals or options it will even present to the President, and I know the President has not seen those as yet.

So I think it would be premature for me to get into a discussion of what are hypothetical options that have not yet gotten to the point of being sent to the President for consideration, and I'm sure that as these are more fully worked out that there will be interchange I would hope between the administration and this committee as well as others.

With respect to taxing savings, I myself have strongly opposed taxing savings, but I would draw the following distinction. A tax on saving that was just on revenue should be distinguished from an increase in insurance premiums where people are getting a defined product, for example, deposit insurance.

If we examine interest rate differentials, people are willing to make deposits in depository institutions that provide FSLIC or FDIC insurance at substantially lower rates than they could get in uninsured deposits, for example, in money market mutual funds, and therefore I think that there is a prima facie case that the insurance is valuable and that providing it is a service.

I don't want to sort of get into the kinds of semantics and discussions that now Director and then Director Designate Dorman had

at his confirmation hearings, but my impression is, whether this is a good or bad idea or not, my first inclination is to consider it as it has always been since FDR introduced it as a self- funded insurance system, which is currently undercapitalized for a variety of reasons.

But I do in general support the idea of minimizing taxes on savings. I would not characterize this proposal, if I understand it fully, as a tax on saving. I would characterize it as a increase in insurance premiums.

Senator HEINZ. Let me go to two other subjects, if there is time. The conventional wisdom is that the trade deficit, is significantly impacted by the existing Federal budget deficit. If that conventional wisdom is right it means that if we eliminate the budget deficit we can eliminate the trade deficit.

Now most people who have studied this issue it isn't that simple. Most of our trading partners like Japan, have budget deficits, when measured as a percentage of GNP, are much bigger than our own. Somehow these countries manage to have rather substantial trade surpluses. None of our major industrial trading partners have much, if anything, in the way of a trade deficit. Most of them have substantial trade surpluses.

What is it that they are doing that we are not? How can they with their big budget deficits run trade surpluses? What lessons are there for us?

Mr. BOSKIN. Well, the lesson is that you have to think of the Federal budget deficit in the context of overall national saving, including private saving, State and local surplus and household and business saving and compare that to the level of investment.

It is certainly true that Japan has a budget deficit, but they have a much higher rate of saving than do we, and even when we subtract their budget deficit from their much higher saving rate, their national saving exceeds their investment. So they have excess funds.

Senator HEINZ. So they have a lower cost of capital.

Mr. BOSKIN. They both have a lower cost of capital and they can be a creditor to the rest of the world because they have enough saving that it exceeds their investment and we are in the opposite situation.

Senator HEINZ. A well taken point. Let me proceed from there. There are only three real levers that you have to improve the competitiveness of a nation; first, labor productivity which tends to be a function of educational level and an unquantifiable value called motivation; and management and its acuity and; third, cost of capital. Labor, capital and management usually are thought to be the determinants of how good you are. Where is the main leverage for the United States in the first 4 years of the Bush administration if Gramm-Rudman-Hollings is the game in town that we play and win that game? What else is there that will impact any of those three critical variables?

Let's assume the budget deficit is going to stay on that track. What else can we, should we and must we do to be a winner in the international game?

Mr. BOSKIN. If the budget deficit stays on that track, I would expect, as has happened when Gramm-Rudman was first passed

and elsewhere, I would expect interest rates to decline some and we would be giving, as some people mentioned earlier, the Federal Reserve some elbow room they need, and I would expect that to put a little bit of an impetus into investment in education, investment in tangible capital and into housing. I think that that boost to investment and investment that is generating and incorporating the newest technology will also help our worker productivity. So I believe that is by far the single most important thing to do is to reduce the budget deficit.

Senator HEINZ. I understand that. But do you believe that our cost of capital would be equal to or below that of Germany and Japan if we did that?

Mr. BOSKIN. I believe the differential would shrink noticeably.

Senator HEINZ. I believe that, too, but that's not my question.

Mr. BOSKIN. Do I believe it would be that low?

Senator HEINZ. Yes.

Mr. BOSKIN. No. I do believe the differential would close substantially.

Senator HEINZ. Then unless we deal with lowering the cost of capital, aren't we inherently prejudiced in our ability to compete?

Mr. BOSKIN. That is one component and there are a variety of other things.

Senator HEINZ. I understand, but other countries are educating their people as fast as they can. Germany is no slouch and Japan is very good. Assuming that they are just as good as we are at educating their people and at motivating them, does that not mean that if that is so, and it is a hypothetical question in that sense, if we are smart enough and creative enough to do so, that we would be well advised to take other steps to reduce our cost of capital so that we are internationally competitive? If we do not, is there not reason to believe that we cannot be internationally competitive over the long term?

Mr. BOSKIN. Well, you are certainly correct that if our cost of capital stays perpetually above that of our trading partners and it is not offset somewhere else through extra labor productivity, et cetera, that we would be at a competitive disadvantage.

Now the facts of the matter are, sir, in the last couple of years we have seen a dramatic turnaround in our international position. The OECD in examining the relative cost of production and competitive position of the United States relative to our trading partners from a point where we were quite uncompetitive in the early to mid-1980's has come down not industry-by-industry necessarily, but overall has become much closer to even on that score.

But you are quite correct that the cost of capital is a major component of our competitiveness. Reducing the budget deficit and getting interest rates down is one component of that, but if these other countries habitually have very high saving rates which help them have much lower interest rates than we would have even if we get our budget deficit under control, then that is something that we would have to address, that's correct.

Senator HEINZ. Thank you.

The CHAIRMAN. Thank you very much.

Senator GRAHAM.

Senator GRAHAM. Thank you, Mr. Chairman.

I apologize for having to leave for another meeting and I hope my questions are not repetitive.

I would like to focus on a couple of questions. One is the Social Security issue which has been raised I know earlier. I sense that there is general agreement between yourself as an economist and among us as politicians that it would be desirable to segregate the Social Security trust fund from the balance of the Federal fiscal accounts for purposes of laying out the reality of our deficit circumstance. Is that a correct statement?

Mr. BOSKIN. Well, I'm afraid I have to elaborate, if I may, sir. As I mentioned earlier, and I'm sorry to the other Senators if I am repetitious in this regard, there are two issues here.

One is to examine the macro-economic impact of the Federal Government's budget position. By far the most important and primary measure is the overall state of the unified budget deficit. I think that we have to keep that in mind unless we ignore that.

It is certainly important and, to the best of my knowledge, the Congressional Budget Office, the budget of the President and so on does provide information about the composition of revenues and outlays and deficits between on and off budget and between the trust fund and the general situation, and I believe that it is highly desirable that that supplemental information be provided.

I do believe that we need to continue to move toward a reduced deficit on the unified budget deficit, and once we have achieved that, or as we approach that and as hopefully we all hope will become a reality in the early 1990's as we move to that, then I think we have to move to a situation where we gradually get to a situation where we can protect that surplus directly.

Senator GRAHAM. So I think the answer to the question is yes, but with a chronology as to what needs to happen in order to get to that objective.

Mr. BOSKIN. That's correct, sir. I think it would be imprudent to make macro-economic policy and overall budget policy on other than a unified budget basis for right now.

Senator GRAHAM. If this issue of the budget were a theoretical one of having access to information and being able to make judgments, I would have no reservations with what you have said, but by adding the Gramm-Rudman- Hollings mechanism and looping into that mechanism the surpluses not only of Social Security but of other Federal trust funds in determining what our national targets are, it seems to me we've moved it from theory to both symbol and to the reality of how we are going to be acting, and in that process have created maybe some unintended disincentives to prudent management of our Social Security and other trust fund responsibilities. That's an editorial statement.

My question is could you, not necessarily today, but possibly for a future meeting with the committee or supplement in writing after this meeting, give us your thoughts as to what would be a prudent course of action and what should be the milestones that would indicate prudence of movement in other areas?

Mr. BOSKIN. I certainly will, sir. I would be delighted to do that in either or both venues. Let me just repeat that I think in general as we get beyond 1993, if we are successful in moving to a balanced budget on a unified basis, we ought to be, in my view, moving

toward a surplus on a unified basis to increase the national saving rate. I said that earlier and I think that is quite in accord with what you are saying, but I would be happy to come before this committee or any other committee again to explain my views in detail on that.

Senator GRAHAM. One last question on this before I go to the second topic. Would you apply the same basic rationale to the other major Federal trust funds, such as the highway trust fund and the aviation trust fund as you have just done to Social Security and, if not, what would you recommend in terms of their long-term treatment?

Mr. BOSKIN. Sir, I think you have to take account not only of the revenues that are coming into the trust funds, but of the outlays and whether just because the revenues are coming in we need to spend that much. But there are some areas that perhaps in the wisdom of the Congress and/or the administration that we ought to spend more, and there are some areas where maybe more is coming into the trust fund than is desirable to spend at that time.

So I would want to look at it in that overall context. I wouldn't want to have a mechanical rule that said that you had to spend every dime that came into any single trust fund that year on that purpose without any serious scrutiny about the desirability and the cost effectiveness and the productivity enhancement or the target effectiveness of delivery services that came on the outlay side. So I would approach it in that general context.

There was a broader question which came up earlier that Senator Riegle raised about the overall accounting mechanisms we use, and throughout our history we have kind of vacillated. We don't have a separate capital account and there are issues of how we deal with surpluses and deficits when it's a cash-in/cash-out budget. That may help some on the discipline on the spending side, but when we have had periods of our history where we have had a big investment boom, whether that was building the interstate highway system, et cetera, one could benefit by having the additional information along the lines you're suggesting.

The CHAIRMAN. Senator Graham, you have only had one occasion to question. If you had another question you wanted to raise, I think Senator Sarbanes and I would agree for you to do so.

Senator GRAHAM. I would like to ask on the flexible freeze. Having had executive responsibility in a State which has a constitutional mandate of a balanced budget, I think we are soul mates in terms of maybe our appreciation of a flexible freeze concept as to how to deal with setting priorities. It's very disciplining to know that you've got at the end of the day to have a balanced set of books.

It's also as a political person I know easy to talk about the areas in which you would like to increase spending, and you've mentioned some, AIDS research, drug enforcement, education, environment, et cetera. Each of those carries a counterveiling recognition that you've got to have some areas to reduce in order to stay within your flexible freeze, and I assume that we're going to get detail on that on February 9.

Mr. BOSKIN. That's correct.

Senator GRAHAM. From your perspective as an economist what are you going to recommend to the President as the areas that he should look to for those counterveiling reductions that is below the inflationary level in order to achieve a flexible freeze and to do so in a way that would not be economically dilatory?

Mr. BOSKIN. Well, Senator, let me give you the context in which I would make that advice.

First of all, I think it is not the purview of the Chairman of the Council of Economic Advisers to get into the details of particular spending programs, et cetera, and make that judgment. That is properly the purview of the President in presenting his proposals and the purview of the Congress in its budget process.

My primary emphasis is on getting the deficit under control, and I repeat that that is to improve our national saving, increase our investment and our productivity and our international competitiveness and our growth.

That said, let me make several points. One is in the areas that have been identified and that you mentioned. The amount of money now being spent is rather modest and one could have some substantial percentage increases without that adding a whole lot of dollar amount, but that will have to be found everywhere else in the budget other than Social Security. Everybody in the Cabinet and everybody who has a line responsibility for any part of that, and certainly Director Darman, are going over every one of those accounts to find every single thing that we can where we think a program is not as target effective or cost conscious as possible and where savings can be made. And where there are tough, painful choices, that is what the President will do.

Senator GRAHAM. This is my final question, Mr. Chairman.

When you advised Candidate Bush on this approach you must have done a sufficient analysis of the Federal budget to be intellectually satisfied that it was a prudent recommendation and one that in fact could be accomplished.

Mr. BOSKIN. That's right.

Senator GRAHAM. At about the time that that conversation was probably going on in the middle part of last year, the Chairman of the Federal Home Loan Bank Board testified before this committee that the resources that were available to the Savings and Loan Insurance Corporation would be sufficient to meet its likely obligations.

Since that time that statement has been overtaken and we are now talking about substantial resources from somewhere beyond what the insurance fund as currently constituted can provide.

Was your assessment of the capacity of a flexible freeze in any way predicated on the representation that there would not be a demand on other Federal resources to meet the FSLIC crisis, or had you factored that into account, the comments of the Chairman of the Home Loan Bank Board to the contrary notwithstanding?

Mr. BOSKIN. Senator, at that time we assumed that there would be some modest cost, less than some people are projecting now, but the method of finance and the method of capitalizing FSLIC and the reforms that this committee I am sure and as I understand now has 2 weeks of hearings to go over, were not dealt with in great detail.

I think that the history of this story is that the view of how large the problem might be and the Federal Home Loan Bank Board's ability in financial and personnel resources to work off what became a much larger problem as they are now estimated were not fully anticipated then.

But let me remind you that the estimates we hear are the total cost over many years of providing the capital and they are not the annual cost on the budget of, for example, paying interest on any bonds that might be involved or whatever it happens to be.

So I think we have to be cautious in adding these very large estimates we hear, which is a one-time stock of assets that must be created, to the annual flow of the deficit.

Senator GRAHAM. So if you had known at the time that you recommended the flexible freeze to Candidate Bush what we know today as to the circumstances of the Federal Deposit Insurance Corporation you would have still made the same recommendation as to how to approach Federal fiscal policy?

Mr. BOSKIN. I believe so, sir. It's hard to go back to a hypothetical situation in that kind of a context, but I think I would have so advised, and there will be some modest additional annual funds that will have to be accounted for somewhere in some way.

The CHAIRMAN. Thank you, Senator Graham.

Senator SARBANES.

Senator SARBANES. You would just have made the freeze more flexible, isn't that the case?

Mr. BOSKIN. That's one way of describing it.

Senator SARBANES. It's a marvelous invention actually. I mean any additional problem that comes along that requires adjustment, you just introduce further flexibility.

First of all, Dr. Boskin, you undertook to appear and testify before any duly constituted committees, and while your confirmation is handled in this committee since we have jurisdiction, a good deal of your testimony will be before the Joint Economic Committee, and as a former chairman of that committee I want to make sure that you understand that undertaking to reach to requests by the Joint Economic Committee for your testimony.

Mr. BOSKIN. It certainly does, sir, and it will be an honor and a privilege. I have done that as a private citizen in the past, and I've worked with Senator Bentsen. I have known Congressman Hamilton over the years and have given him advice, and I look forward to working with you and him and the other members of the committee.

Senator SARBANES. Do you intend to do at least an abbreviated or an economic report subsequent to the President submitting a revised budget to the Congress?

Mr. BOSKIN. Sir, I don't believe there would be the time and resources available to do an entire new economic report. I have agreed, subject to my confirmation by the Senate, to testify before the Joint Economic Committee and present my views as they reflect the last economic report and update since then in my own views.

Senator SARBANES. So I take it that means a fully developed statement that would in effect reflect the economic decisions of the Bush administration?

Here's the problem. We have had an economic report submitted to the Congress by the outgoing administration. The new administration is in effect going to submit a new game plan, economic game plan, and it seems to me reasonable for the Congress to expect the Council to submit, and I'm not talking about giving us a document of that sort, but to submit a major statement that takes into account the revised economic game plan of the Bush Administration. I take it that would be what you would furnish.

Mr. BOSKIN. I think that is entirely appropriate. It would not only incorporate the revised economic game plan, but what has happened in the economy pursuant to the preparation of this report, sir.

Senator SARBANES. That would be very helpful.

I have some questions and I'll try to get them in very quickly before my times expires. Just a couple of questions on analysis.

In considering the macro-economic impact of the Federal budget, is it appropriate to consider all of the trust funds, including Social Security?

Mr. BOSKIN. I believe that is the best first place to start, sir.

Senator SARBANES. Now you indicated that earlier and then you said right now, but that would be the case at any time, would it not?

Mr. BOSKIN. Yes. If I said right now, I think I was referring to the idea that was suggested by some of the Senators of separating that out for other purposes to provide additional information or to make some things that people thought weren't clear enough more clear to the American people. But certainly the overall macro-economic impact and the impact on financial markets and the Government's borrowing needs is best estimated by the overall status of the unified budget.

Senator SARBANES. Now do you think that the unified budget should always be in balance or surplus?

Mr. BOSKIN. No, sir, I do not. While I would hope that we will eventually get back to a situation in the United States hopefully by the mid-1990's where the general average is for at least a small surplus or balance, I think it would be imprudent to run a balanced budget on a year-by-year basis.

If you consider a situation where everything is in balance and if there was a severe downturn in the economy, and I don't predict one any time soon, but in some hypothetical future year, I think it would be unwise and indeed imprudent and improper to have a substantial cut in spending or a substantial increase in taxes in order to try to balance the budget. I think that would worsen the recession and that would not be a wise idea.

Senator SARBANES. Now at the moment we've got 5.3 percent unemployment and therefore I think a strong case can be made that we should be actually reducing this deficit because we have a fairly strong economy, although the 5.3 percent as an historical figure is not all that good if you take the entire post-war period. It looks pretty good in recent years, but not over the post-war period.

Gramm-Rudman of course puts us into absolute figures in terms of deficit reduction. Is it not possible that under certain circumstances trying to achieve those figures could precipitate the econo-

my downward and thereby give us a large deficit than what we had or what we are trying to deal with?

Mr. BOSKIN. That is correct, sir, and not only would that be bad from the standpoint of dealing with the deficit, but it would lead to rising unemployment and hardship on Americans and would be unwise for that purpose.

Senator SARBANES. Now I want to ask just a line of questioning about economic policymaking in the new administration as you see it and what you understand the role of the Council will be and in particular your role as Chairman of the Council.

First of all, when can we expect your two colleagues to be submitted to us? Do you have any idea on that issue?

Mr. BOSKIN. We are working on that and I hope in the next few weeks. I have asked for a variety of reasons, including some degree of continuity, Council member Tom Moore, who is sitting right here, to stay on for some time and he has agreed until we can work out a smooth transition, but I think with the Chairman and both members leaving in this difficult time and in this transition time would have been unwise. He has served ably and well and I'm glad to have his services, but I expect that we will in the next several weeks move to name and move to have an orderly transition of the other two members.

Senator SARBANES. Well, I think it's highly desirable, if there is going to be a full new Council, and I take there is——

Mr. BOSKIN. There will be.

Senator SARBANES [continuing]. That it be gotten into place as quickly as possible, and therefore I'm very pleased that the Chairman has moved your hearing as quickly as he has, and I'm sure that he will be prepared to move equally as quickly with respect to the other two members of the Council.

Mr. BOSKIN. I greatly appreciate that.

Senator SARBANES. I assume you have considerable influence within the administration on the selections for those posts.

Mr. BOSKIN. That is correct.

Senator SARBANES. And it seems to me important that they pressed forward.

Mr. BOSKIN. I agree with that, and thank you for that.

Senator SARBANES. What role do you see the Council playing? Your predecessors over the last 8 years have experienced varying shades of difficulty in that regard in terms of being economic policy-makers, and in fact some of them were perceived as being completely outside of the pale with no influence whatever.

Do you have any understandings or appreciate what role the Council and you as the Chairman of it will play in the economic policy-making of the Bush administration?

Mr. BOSKIN. Well, I certainly do, sir, but let me first say that the Council will live up to the requirements and expectations as mandated in the Full Employment Act of 1946 and the 1978 Balanced Growth Act. That requires us to do a variety of things and to do so with diligence and with professional integrity and we will make sure that we comply by all of those.

But, in addition, I believe that the Council of Economic Advisers will provide advice to the President and other senior members of the administration and consult with Congress in testimony and so

on on economic policies that help the U.S. economy perform up to its potential.

My understanding is that I will be the Chief Economic Adviser to the President. The Treasury Secretary will be the Chief Economic Spokesman for the administration and other persons will have the primary, as rightly so, will have the primary responsibility in various areas, for example, a Cabinet Secretary in his or her particular line area, and I think that is as it should be.

I have received in the past in my dealings with the President prior to his becoming President, and I have since he became President, the promise and the expectation that I will meet with him regularly and often any time I need to and there will be regular meetings scheduled and I will be able to provide him advice in a timely and efficient manner.

Senator SARBANES. So you expect to have frequent and regular meetings with the President?

Mr. BOSKIN. Yes, I do.

Senator SARBANES. And do you expect there to be a mechanism that brings all of the policy-makers together on a regular basis, particularly the Chairman of the Council, the Secretary of the Treasury, the head of OMB and possibly the Chairman of the Federal Reserve?

Mr. BOSKIN. Well, yes, there are a variety of such institutions. There was an Economic Policy Council that existed in the Reagan administration and will be the preliminary ways things will be organized in the Bush administration. All save Chairman Greenspan that you mentioned will be members of that, and there will be several others. And as different economic policy issues come up other people will come to those meetings if they have line responsibilities for those things.

There is a tradition of regular meetings between the Council of Economic Advisers at lunch with the Board of Governors. That will continue. There is a tradition, and I believe it will continue, of a breakfast meeting hosted by the Treasury Secretary every week that would include the Chairman of the Council of Economic Advisers, the Director of OMB and one or two other senior policymakers, for example, the Secretary of Commerce.

So I think that there will be active, ample, and careful interchange of ideas in all these venues and the Council will participate fully in them.

I believe that it's important to point out that the making of economic policy within any administration, this one or any others, involves lots of people and lots of tradeoffs, and it is my hope to provide the President and everybody else the best professional advice I and the Council can summon. It is being set up in a way that the input will be made available, and I have no reason to doubt that.

Senator SARBANES. Well, that's encouraging and it's something that we will try to keep tabs on. It was really a shocker in the previous administration to ask some of these chief economic policymakers when was the last time they talked to the President.

Mr. BOSKIN. Yesterday, sir.

Senator SARBANES. I'm not asking you, but I asked them, and that's a good answer, and I appreciate it.

But in the previous administration we would ask some of the major economic policy-makers when was the last time they had actually directly spoken with the President on economic matters, and it would have been a matter of months and months.

Mr. BOSKIN. I cannot anticipate that happening in this situation both given the President and the structure he has set up and the other people in the White House, Governor Sununu and myself and the relationship we have. I would be shocked if that occurred.

Senator SARBANES. Thank you.

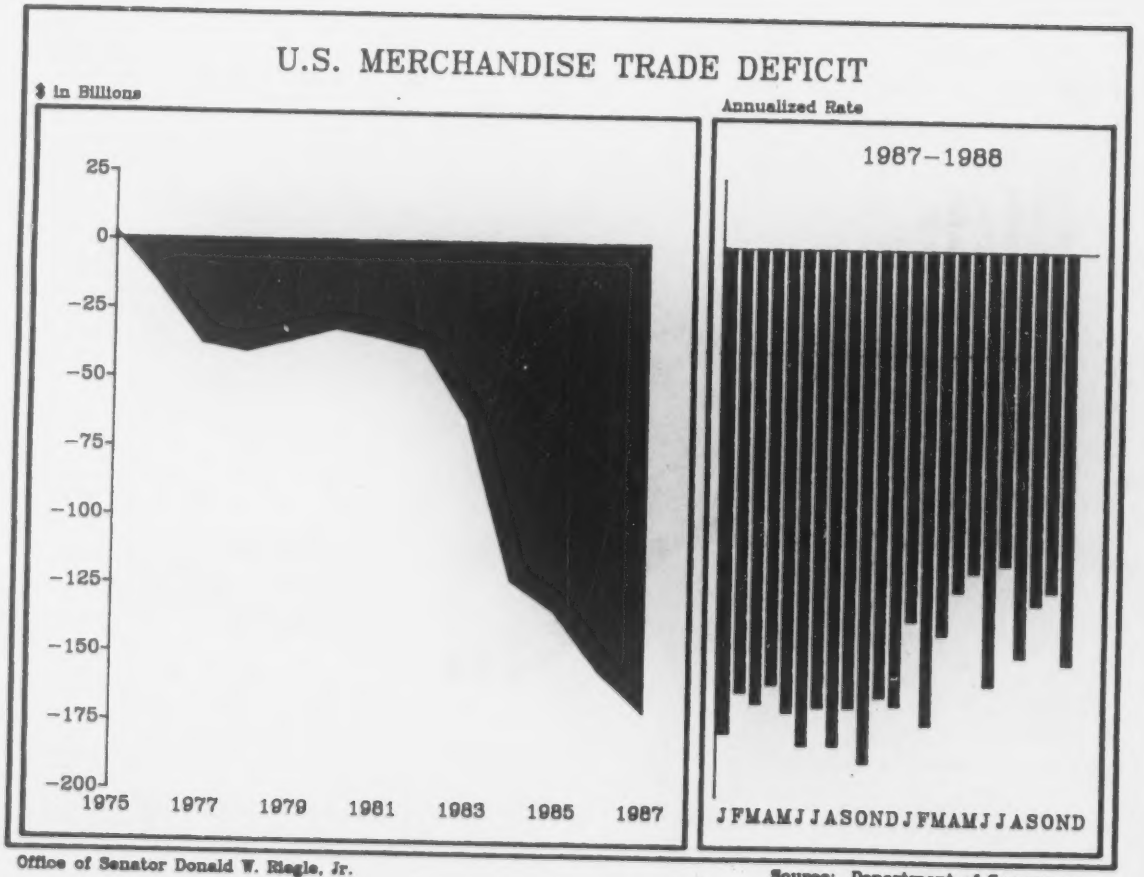
The CHAIRMAN. Thank you, Senator Sarbanes. I think it's very important to have those points on the record.

I want to take you through one more issue, it won't take long, and then we'll be finished for the day.

I'm going to step over and refer to some things on these charts, (see charts 1, 2, and 3) and then I'll come back and pose a question or two to you from the witness table here.

You and I had a previous opportunity to discuss this information that is here when we met privately, but I want to have your response on the record today.

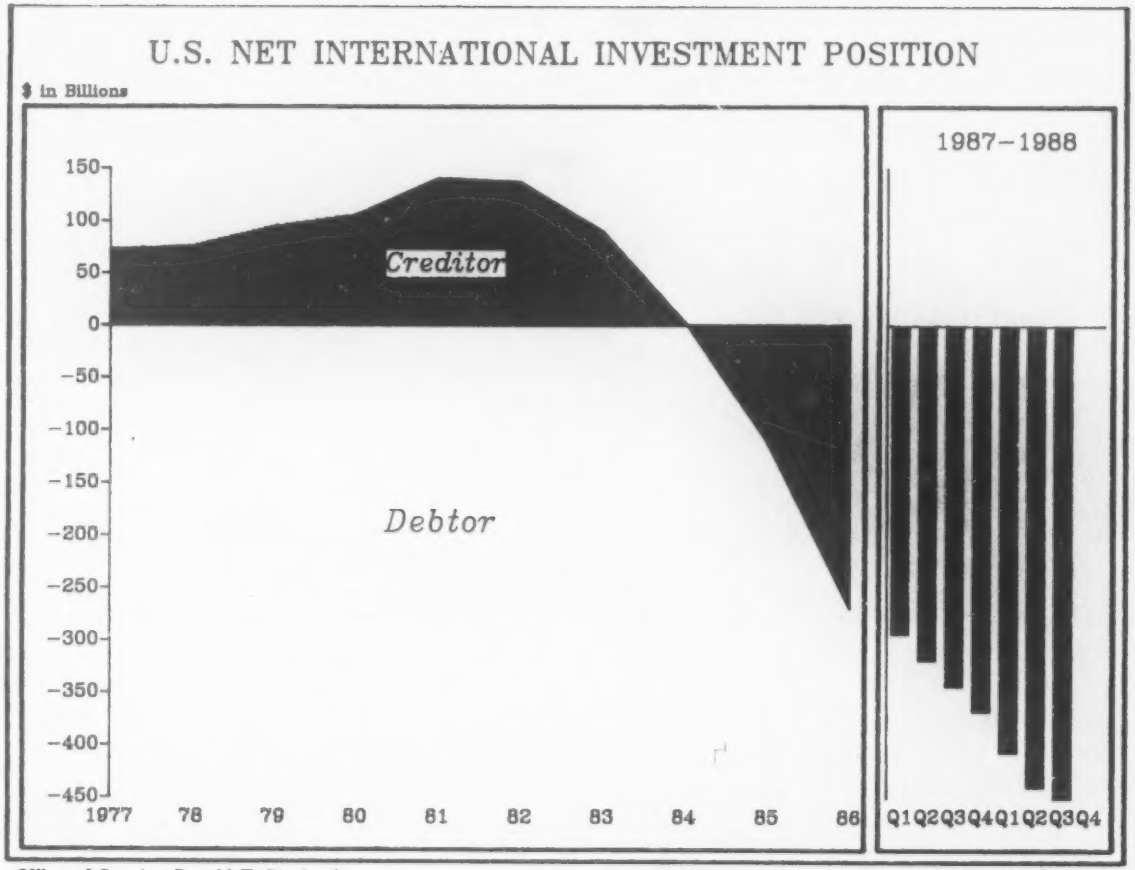
CHART 1



Office of Senator Donald W. Riegle, Jr.

Source: Department of Commerce

CHART 2

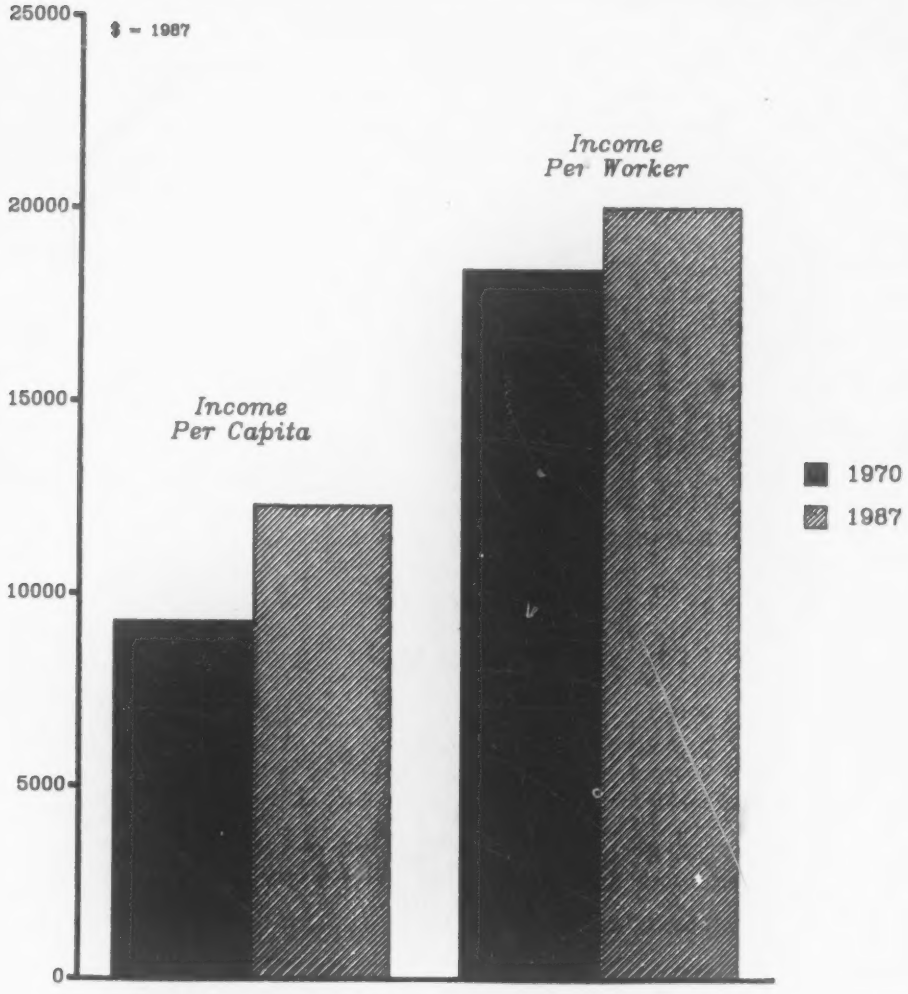


Office of Senator Donald W. Riegle, Jr.

Source: Department of Commerce

CHART 3

IN REAL TERMS, PER WORKER INCOME GREW BY ONLY ONE THIRD OF ONE PERCENT PER YEAR SINCE 1970.



The CHAIRMAN. This first chart shows the development of the U.S. trade deficit since 1965. The line at the top here of course is the balance of trade line and it shows that we went into a deficit position in the mid-1970's. We ran a deficit for several years of about $30- or $40 billion here, and then beginning in the early 1980's we broke into a very severe trade deficit position taking us down to roughly $170 billion through the year end and the full year of 1987.

What I have done on this side of the chart is to take the year 1987 and all the months for which the data is available in 1988 on a monthly basis, and I have expressed that monthly data on an annualized calculation basis so that we have some basis of being able to see the degree to which we are getting sustained improvement, the so-called "J" curve effect that everyone talks about.

With currency values changing and our productivity improving and product quality improving and knocking down foreign trade barriers to our goods and so forth, we should start to see some kind of a very steady and strong improvement taking us back up out of the deficit position hopefully at least to a balance and presumably, if we are good enough, up into a surplus, although it has been a long time since we've seen even a glimmer of a surplus in the trade accounts.

I'm concerned, and there is an increasing number of serious observers who are concerned, that the improvement that we have started to see through the 11 months of 1988 that have now been posted that we have had some gain, but it's not all that great, and there is the latest evidence that would seem to appear that maybe we're leveling out at a trade deficit level of somewhere in the $120- to $130- to $140 billion level and that we may find ourselves not continuing to come up, but sort of leveling off in a deficit band that would be about here, which would have some very serious implications for the future, at least my view would be that that would be the case.

In any event, the data that we have is only this current in terms of what has been announced by the Commerce Department, and that takes us through the data that was released about two 2 weeks ago in terms of the November information because there is a lag in this data.

If you think of this chart as an income statement on trade, I have been very much concerned about what's happening to the balance sheet, our international balance sheet, if you will, vis-a-vis other nations. And it's very striking to me that again, if you take this line here, which is a zero line, and you look at what our performance has been since the late 1970's, we were a creditor Nation and therefore in a surplus position up through the early 1980's.

Then all of the sudden we began to see that erode and we crossed this debtor nation line for the first time, by the way, since 1914. So we've managed to stay in a surplus position through the depression, the World War, the Korean War and so forth, but we came on down into this deficit position and we have continued to ride this curve, and this takes us through 1986, and what I have done here is I have posted the quarterly add-ons as they have been released for the year 1987 and on into 1988 in terms of what we have available.

Now obviously because I have a white space here, it shows off the continuity of this line some from what it would be if all of that were compressed.

My concern as I look at this is two things, first of all, this radical change in national circumstance in terms of what our contemporary experience has been for more of the century, but also if you take say from this point in 1982 to this point through the third quarter of 1988 and you look at this rate of change, and you have studied economics and taught economics for a long period, and for those who have had some chance to study economics, you don't see too many trend lines on things as fundamental as this that look as stark as this.

I mean this is an incredible rate of change, if you will. Now if we turn out of it, that's one thing. If we continue to ride it down, I think it portends a very different circumstance.

And now if I may, let me just go back and pose a couple of questions on it.

The New York Federal Reserve Board has estimated that sometime in the early 1990's that that trend line will continue and that we're going to find ourselves hitting the $1 trillion international debt figure, not that that is a particular milestone other than the fact that it certainly sounds pretty potent and pretty alarming, but we are going to go right on through that level and on out, unless things change quite dramatically, to higher and higher levels of international debt.

My question to you is this. When you think about as an economist and now as the Chief Economic Adviser for the country, and we think about reaching the point not very far ahead of us where these trend lines will take us to a $1 trillion international debt position and as we go on beyond that, where is the point at which we would start to find ourselves in a situation that we really need to worry about the structural, economic feedback effects and all of the other things that attend that kind of a national performance in the international economic system?

Do we need to be alarmed at the prospect of hitting $1 trillion? Can we take that in stride or do we need to really sort of worry if we go past that on to a $1½ trillion or $2 trillion? I would like you to give me some sense as to how you assess that kind of a trend line and where it appears to be taking us, what are the implications for the economy for that, is this something that needs direct and serious attention, and let me just stop at that point.

Mr. BOSKIN. Well, you have posed a number of related questions, Senator, and let me do my best to answer them.

Let me first start by saying that as you indicated in earlier questions, we have to get the accounting straight, and I don't at all quibble with the rate of change, but our assets abroad which were generated much earlier in the 1950's and 1960's relative to foreign assets coming here, and in the 1980's they are carried at book value. So I think if you tried to do the proper accounting and you just moved that over a little bit, we've just about become a net debtor in the last year or so.

We finally have a situation where we are paying net interest to the rest of the world. That happened for the first time in 1988. So the rate of change and the movement in our international asset po-

sition is correct, but there are some technical issues. So I would put it in 1988 rather than 1984 or 1985. But your general point is correct about the rate of change.

The next thing I would ask myself is not only how is our economy doing currently, but what is actually going on with the funds that are coming into the United States from abroad.

Let me first say that we are certainly better off with the foreign capital than without it. If that foreign capital had not come into the United States, I think we would have had some untoward consequences.

The Chairman. Now let me just ask you. When you say foreign capital, are you referring principally to equity capital that is invested in brick and mortar and job creation directly, or are you talking about debt capital that is loaned to us for a period of time at an interest rate and then withdrawn?

Mr. BOSKIN. Well, let me say that, first, with respect to foreign direct investment that's clear, that when we have whatever agreements we have that have foreigners build plants or purchase tangible assets here, that can add to employment, wages, et cetera.

I imagine there is not a single one of the 50 Governors that doesn't make an international trip to try and attract some foreign investment to their States. That is a modest fraction of the total and more of it is portfolio investment and a lot of that purchasing our government bonds.

Now that is not quite the same thing. Even though we are borrowing that or they are purchasing our government bonds, that is not quite the same thing as making a loan at a bank with the specific requirements that accompany that. This is coming from a large number of places. For the foreign direct investment the largest investor is Britain, Holland is second and Japan is less than half of Britain.

But when we think about the fact that we have seen some growth in the fraction of our national debt held by foreigners, it's still rather modest, and our interest cost to service this debt is rather modest. What we want to make sure is that we don't get into a situation where the cost of servicing this external debt in terms of interest, dividends and rents that are paid to the owners of that capital, foreigners in this case as you chart indicates, becomes overly burdensome on the economy relative to the benefits we get from having those resources here.

So if the funds come in and they finance higher investment than what otherwise would occur, workers will have more employment, we'll have higher productivity and we'll be able to out of that extra income be able to pay that back. So it's interrelated with that.

We have seen the real investment rate, investment adjusted for the investment goods deflator, at rather historic highs for the last 2 or 3 years and there is some controversy as to what exactly caused this. Is this because we are far along in expansion or is it a new ball game that we are going to be investing a little bit more?

But my general view is that we have to be concerned, I wouldn't use the word "alarmed," about allowing the external debt to grow and/or the rate of return on the assets foreigners own here net above and beyond what we own abroad to get high relative to our ability to service that debt. That is quite small now, but as you

properly point out with the size of the net debt growing, and we can argue about the accounting procedures, but you are quite correct that it is growing, that we ought to be doing what we can to have Americans finance our own investment.

There are many reasons foreign funds come into this country. One of them is that we are safe, rates of return have been high and there is no fear of expropriation. We're a quarter of the world's economy, and about the period you've indicated, in the early to mid-1980's many foreign countries allowed or freed up the investments in their pension funds and insurance companies and allowed them more liberal rules in investing abroad, and naturally the first place they came was a country that's growing rapidly, that has high returns, that is safe and is a quarter of the whole world's economy.

So some part of that is that we are a desirable place to invest, but certainly the budget deficit—which has drained our national saving rate below our investment rate, and there are only two things that can happen in that case, we either invest less or we make up the difference from abroad—has contributed to this.

So I certainly would say that my concern is twofold, not to let this get to a point where we have the prospect of not being able to service it easily and that we make sure that we are making productive use of the capital not only that Americans are providing, but that foreigners are channeling into the United States. If it was all going to finance consumption, I would be very concerned. Some fraction, not all, is going to finance extra investment.

The CHAIRMAN. Well, I think a fairly substantial part is going to finance consumption. I mean you're not asserting that that's not the case, are you?

Mr. BOSKIN. No. I think it has been split roughly 50/50 actually. Well, you have to assume what would go on in investment otherwise, and that's a difficult counter fact to pose. The real investment rate has risen about two percentage points of GNP in the last several years. The external debt or the net foreign investment is about 3 percent. So whether we argue that ⅔ or ½ or whatever, roughly that would be going into national consumption versus national investment if we argue the investment rate would have been exactly where it was historically had it not been for this.

The CHAIRMAN. Do you know offhand of the split of money coming into this country from foreign sources, if you take all of it, the part of it that would represent money that is lent to us in some credit form and the amount that is literally invested here in what you might think of as an equity from?

Mr. BOSKIN. Well, if you're referring to tangible investments like building a factory or buying a hotel or something of that sort, that has generally run, I believe about a quarter, but it varies from year to year.

The CHAIRMAN. The tangible investment?

Mr. BOSKIN. Yes, and some years would be lower and some years would be higher.

The CHAIRMAN. So that would mean that two-thirds is money that is lent to us that in effect is a temporary lending, or it could be I mean, and we pay interest on it and of course we are obligated to pay the interest and to pay the principal back at some point.

Mr. BOSKIN. As as long as we stay strong and prosperous, it could go on for many years or it may not go on for many years.

I share your view that we should not only not run budget deficits of this order of magnitude continuously, that that would be very damaging to our economy, but that we should be moving to a position where we finance our investment ourselves.

The CHAIRMAN. Now let me just take it a couple of steps further. If roughly three-fourths represents borrowing, just debt, people lending us money to spend, which we then have to pay back, and roughly one-fourth represents in effect equity investments, and you made two differentiations, a foreign source of money that comes in and builds say an automobile plant or some kind of a factory or what-have-you, versus buying other kinds of hard assets, buying a hotel in New York or land in Hawaii or whatever it happens to be. Do you know the rough split of the quarter that tends to go into hard asset investment?

Mr. BOSKIN. I couldn't give you that off the top of my head. I would be happy to get back to you about it, sir.

The CHAIRMAN. Do you have a sense for how that may split out?

Mr. BOSKIN. Well, I think a pretty substantial fraction of it goes into industrial activity, plant and equipment and a large fraction of that is accounted for by European investment.

The CHAIRMAN. Would it be fair to say that when we are running a large trade deficit, and if you take the bilateral deficits, take the Japanese, for example, if we are running a bilateral deficit with them where they are taking $40 billion or $50 billion a year net out of the trading relationship, and in effect that money moves from us to them and they turn around and lend that money back to us by buying government securities, if roughly $3 out of every $4 that comes back comes back in terms of a loan to be paid back in the future, in effect when we are running these large trade deficits year after year and sending the money over to pay for the foreign goods and then we borrow the money back, aren't we in effect borrowing back money that used to be ours that is now theirs? Is that what we're doing?

Mr. BOSKIN. I wouldn't phrase it quite in that way, and I'm trying to be as succinct and use as much English rather than technical jargon as I can. There are two sets of relationships going on here. One is the flow of capital and the other is the flow of goods, and there are different opinions among responsible economists and government officials and people on Wall Street who believe that the trade flows basically reflect the capital flows and others that believe the capital flows reflect the trade flows.

To give you a hypothetical example, if we were in balance and for some reason foreigners wanted to invest in the United States because we were safe and prosperous and their laws about what they can do with their pension funds changed, et cetera, or they wanted to flee the possibility of expropriation in some country or whatever it happened to be. If that occurred, how would they do that? They would have to get their hands on dollars, and the way they would do that is they would have to sell us more than we bought from them to do the investment.

So I think without getting too technical, the trade and capital flows are kind of determined simultaneously.

Now how much of this reflects the desires of foreigners to invest in the United States versus the causality that you properly pointed out is some part of the problem, that with the trade deficit the funds accrue to foreigners and they turn around and invest, is really an open question.

I believe that a lot of it has to do with the desirability of investing in the United States, but that certainly isn't all.

The CHAIRMAN. Well, if three-fourths of the investment is lending us money, we're borrowing, we are going to pay interest, and we have to pay the principal back also at some point in the future, one of the things that brings that in, and you mentioned earlier rates of return are high. Well, that's true, and that means interest rates are high, and our interest rates are high. They are very high. They are among the highest of any industrialized nation. The English are up there these days, and certainly the Japanese are far lower than ourselves.

So in effect, yes, we are attracting the money, but we are attracting the money because we are offering in effect sort of the premium interest rate at the moment.

Mr. BOSKIN. Well, there are many reasons we are attracting it, but the high rate of return is certainly one of them.

The CHAIRMAN. Well, how much of it would we get if our interest rates were 2 percentage points lower right now than they are?

Mr. BOSKIN. Well, it depends on why the interest rates would be 2 percentage points lower.

The CHAIRMAN. I realize that.

Mr. BOSKIN. If we were getting our budget deficit under control and our inflation rate was falling and the likelihood therefore that the exchange rate would reflect that inflation differential was reduced, then I think we would be getting a substantial fraction of it.

The CHAIRMAN. Yes, but the fact of the matter is that with the mix of circumstances as they are, huge budget deficits, big trade deficits and so forth, in effect it takes this high level of interest rates to attract the foreign capital, and if it didn't, the Federal Reserve wouldn't for one second pay a higher rate of interest than they need to and we wouldn't want them to.

So the fact of the matter is we are boxed in in a situation where we are having to pay high rates of interest to attract this and we may well be a safe haven, but I can't imagine you would assert that tomorrow the Fed could go out and get the same amount of borrowing from abroad at a percentage point less if everything else stayed the same.

Mr. BOSKIN. I think you are quite right, and it's not just borrowing from abroad, but borrowing from everywhere, including the United States.

The CHAIRMAN. I understand, but the part that is coming from abroad is getting bigger, and I'm concerned about the fact that a lot of that money was not much earlier in time, our money. I mean we're having a transfer of money through the trade deficit that is going into foreign hands, that is coming back in modest proportion in terms of hard investment in this country, and I'm all for that, and you're right, the Governors are out there doing the best they can to try to get some of it, but that's a minor fraction, important,

but a minor fraction of the total, according even to your own estimates.

I still don't have an answer to the question of what happens if and when we hit $1 trillion of international debt, $2 trillion and $3 trillion. I don't know the answer myself and that's why I've asked a lot of people.

I asked the board of directors of one of the major investment companies in New York, I won't name the company, but we were seated in meeting, and I asked them what they thought it would mean. These are very talented and high-priced individuals and understand economics and international finance, and I said what happens if the international debt that we owe the rest of the world hits $1 trillion in the early 1990's? What is the implication of that and do we need to worry about it today and maybe get off these trend lines.

They thought about it for a while and debated it, and the bottom line, and I'm paraphrasing, was we're not smart enough to tell you what that means, but it makes us very nervous, and we think and the unanimous judgment around the table, not that they are right, but the unanimous judgment around the table was we ought to find a way to get off that trend line so that we don't get out there and find out what $1 trillion international debt is when we have not been a debtor nation for the greater part of this century.

I don't sense that degree of concern yet. I mean you may have it and I think you have been very forthright and candid today and very measured in your responses, but I have not heard any real sense of concern yet expressed by this administration or the economic spokespeople for the administration say that this is something that is really a top priority and a matter of real concern that you want to get off these trend lines. I haven't heard that, and I wouldn't say that I have heard that yet just now.

Now that may not mean that you feel that way, I want to say that, but I'm looking for the degree of importance that you attach to this and do we have to think about altering our overall economic strategy in a variety of ways, fiscal policy and many other ways, in order to turn these trend lines around or can we continue to ride these trend lines for quite some period of time without any great consequence that we need to worry about.

Mr. BOSKIN. You earlier gave an answer in discussing your sitting around the table with these people in New York that very much is my own view, and let me try to state as carefully as possible.

This is a concern, I wouldn't use the term "alarm," that it's a little bit of uncharted water, that it would be prudent for us to get off these trend lines, as you put it, and the administration is concerned about the trade deficit and it is concerned about these issues.

I don't think anyone can give an answer to how long we can continue to import 3 percent of GNP from the rest of the world. There were people who thought in 1980 that it would be impossible to ever do that. The most we had imported by 1980 was much smaller than that in a given year.

So I'm concerned. I'm not yet alarmed. Nobody can give a definitive answer to whether this can continue for 10 or 20 years or

whether we would be wise to make sure we get off this trend line immediately, but in lieu of that uncertainty and in lieu of the fact that we are in a little uncharted water here, I think it would be prudent for us to get off the trend line.

I think you're exactly right on that, and I very much appreciate the way you've explained what happened in New York because I think that is exactly my view, that we are not absolutely certain.

Now I do want to go back to one point, which is what is being done with the funds and what the economy is doing. We can't just take the level of GNP and subtract the trade deficit and say that is sort of what we are sending to the rest of the world unless we are prepared to make the very strong assumption that the level of income could be higher by the amount of the trade deficit above and beyond what GNP is.

I think as we move to adjust our external imbalances, a variety of other forces will occur. And I think that you've indicated, Senator, some of the reasons we would be getting off this trend line, but I wouldn't just add our trade deficit to the GNP and assume that we can have that immediately. I think that's a common thing. I know you weren't trying to do that, but it's a common perception in the media, and I think that's a little misleading.

But you're quite correct. We are in uncharted water here and we should be moving prudently to get off those trend lines, and you're quite correct that the first place to start is with fiscal policy.

The CHAIRMAN. We passed the trade bill last year in the Finance Committee, and those of us who serve on that committee had a chance to work on it, and it was a response which the President eventually decided that he would sign to try to deal with some of this, not that we can solve all that problem with trade legislation however well written it might be.

But I say that to give you an expression of the fact that the level of concern reached such a high level in the country coming through the Congress that we in fact wrote a major trade bill and President Reagan, who had some skepticisms about it, finally decided that he would sign it, and there would have been the votes to override a veto had he not, and that may have had a bearing on it, but I think that is a very powerful statement and another form of the fact that the concern level has gotten very high about riding these trend lines, and that is just one manifestation of a type of action that the Congress and the Government as a whole has taken just within the last several months to try to impact that in a positive way, at least open up foreign markets and stop the trade cheating that keeps us out and so forth.

You've been very patient today, and I want to say on behalf of the entire committee that we appreciate the candor and the thoroughness of your answers and your willingness to be available ahead of time to meet and talk with members of the committee.

Others will have questions that they may want to submit for the record, and I may do so as well.

I want to close by saying that the very open, direct, and positive spirit that you expressed in your remarks will be fully reciprocated by me and the members of the committee.

We respect the fact that you're willing to serve in the Government at this time and we want to work together. This Government,

while we're in different parts, we all have to synchronize if the country is going to go where it needs to.

So I look forward to working with you, I know my colleagues up and down the table feel the same way and we will move forward on getting your nomination to the Senate floor as quickly as we can.

Mr. BOSKIN. Thank you very much, Senator. I share that appreciation of your openness and your willingness to expedite my hearing. I have enjoyed all the conversations I've had, I have learned from them with the Senators I've had a chance to meet, and I look forward to an open and frank continuous dialog and exchange of views.

The CHAIRMAN. Very good.

The committee stands in recess.

[The committee recessed at 1:20 p.m., subject to the call of the Chair.]

[Biographical sketch of nominee and response to prehearing questions and written questions sent at a later date follow:]

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: Boskin (LAST) L (FIRST) Michael (MIDDLE) J.

Position to which nominated: Chairman, Council of Economic Advisers Date of nomination:

Date of birth: 23 (DAY) 9 (MONTH) 45 (YEAR) Place of birth: New York, N. Y.

Marital status: married Full name of spouse: Christien D. Boskin

Name and ages of children: None

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Univ. of California		(Highest) B.A. Honors)	1967
" " "		M. A.	1968
" " "	9/63 - 9/70	Ph.D.	1971

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Ph Beta Kappa Chancellor Award and Dept. Citation, Outstanding Undergraduate, University of California, 1967
National Tax Association Outstanding Doctoral Dissertation Award - 1971
Scholarships/Fellowships: Univ. of California Scholar Woodrow Wilson Fellow, Ford Foundation Fellow, Kaiion Foundation Faculty Fellow
Abramson Award for Outstanding Research-National Association of Business Economists, 1987
Distinguished Teaching Award, Stanford University, 1988

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
American Economic Association	Economic Education Committee	
National Tax Association		
Western Economic Association	Executive Committee	

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

Stanford University:	Assistant Professor of Economics	1971-75
	Associate Professor of Economics	1976-77
	Professor of Economics	1978-Present
	Wohlford Chair in Economics	Since 1987
Harvard University:	Visiting Professor of Economics	1978
National Bureau of Economic Research:	Research Associate	1974-Present

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

Consultant/Advisor to: House Ways and Means Committee

Joint Economic Committee

Treasury Department

Member National Science Foundation - Research Review Panel

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

See attached list

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Member, Republican National Committee

Several speeches to Republican National Committee

One speech to Democratic National Committee

PUBLICATIONS

Books:

Too Many Promises: The Uncertain Future of Social Security, Dow-Jones-Irwin, 1986.

Reagan and the Economy: Successes, Failures, Unfinished Agenda, Institute for Contemporary Studies, 1987.

Books edited:

The Crisis in Social Security, Institute for Contemporary Studies, 1977.

Federal Tax Reform, Institute for Contempory Studies, 1978.

Economics and Human Welfare: Essays in Honor of Tibor Scitovsky, Academic Press, 1979.

The Economics of Taxation, Brookings, 1980 with H. Aaron.

The Economy in the 1980's: A Program for Stability and Growth, Institute for Contemporary Studies, 1980.

The Federal Budget: Economics and Politics, Institute for Contemporary Studies, 1982 (with A. Wildavsky).

Private Saving and Public Debt, Basil Blackwell, 1986 (with John Flemming and Stefano Gorini)

Modern Developments in Public Finance, Basil Blackwell, 1987.

Economics of Public Debt, MacMillan, 1988, (with K. Arrow).

Journal Articles:

"The Negative Income Tax and the Supply of Work Effort," National Tax Journal, December 1967 (my undergraduate senior honors thesis).

"The Effects of Taxes on the Supply of Labor: with Special Reference to Income Maintenance Programs," National Tax Association Papers and Proceedings, 1971.

"Unions and Relative Real Wages," American Economic Review, June 1972.

"Local Government Tax and Product Competition and the Optimal Provision of Public Goods," Journal of Political Economy, January 1973.

"Economics of the Labor Supply," in G. Cain and H. Watts, eds., Labor Supply and Income Maintenance, Rand McNally, 1973.

"Theoretical Models of Local Government Finance," Proceedings of the 26th Congress of the International Institute of Public Finance, 1973.

"A Conditional Logit Model of Occupational Choice," Journal of Political Economy, March 1974.

"The Effects of Government Expenditures and Taxes on Female Labor," American Economic Review, May 1974.

"Regression Analysis when the Dependent Variable is Truncated Lognormal: with an Application to the Determinants of the Duration of Welfare Dependency" (with T. Amemiya), International Economic Review, June 1974.

"Efficiency Aspects of the Differential Tax Treatment of Market and Household Economic Activity," Journal of Public Economics, February 1975.

"Lessons from the New Jersey-Pennsylvania Income Maintenance Experiment," M. Timpane and A. Rivlin, eds., Evaluating the New Jersey-Pennsylvania Income Maintenance Experiment.

"A Markov Model of Turnover in Aid to Families with Dependent Children" (with F. Nold), Journal of Human Resources, Autumn 1975.

"Estate Taxation and Charitable Bequests," Journal of Public Economics, January 1976.

"Recent Econometric Research in Public Finance," American Economic Review, May 1976.

"The Economic Common Sense of Controlling Nuclear Power Development," in W. Reynolds, ed., The California Nuclear Initiative, Stanford University Press, 1976; also in Federal Reserve Bank of San Francisco, California Energy: The Economic Factors, 1976.

"Social Security and Retirement Decisions," Economic Inquiry, January 1977.

"Notes on the Tax Treatment of Human Capital," U.S. Department of the Treasury, Proceedings of the Treasury Conference on Tax Policy, 1977.

"An Economist's Perspective on Estate Taxation," in The Future of Wealth Transmission, American Assembly, 1977.

"Some Lessons from the New Public Finance" (with J.Stiglitz), American Economic Review, February 1977.

"Effects of the Charitable Deduction on Contributions by Low and Middle Income Households: Evidence from the National Survey of Philanthropy" (with M. Feldstein), Review of Economics and Statistics, August 1977.

"Taxation and Aggregate Factor Supply: Preliminary Estimates" (with L. Lau), U.S. Treasury Compendium of Tax Research, 1978.

"Taxation and Capital Formation: Missing Elements in the President's Tax Program" (with J. Green), in R. Penner, ed., Tax Policies in the 1979 Budget, AEI, 1978.

"Taxation, Saving and the Rate of Interest," Journal of Political Economy, April 1978.

"Social Security and Labor Markets: Theory, Evidence and Implications," American Economic Review, (revision in progress), forthcoming.

"Optimal Tax Theory, Econometric Evidence and Tax Policy," in R. Stone, ed., Econometric Contributions to Public Policy, Macmillan for the International Economic Association, 1978.

"Optimal Redistributive Taxation when Individual Welfare Depends upon Relative Income," (with E. Sheshinski), Quarterly Journal of Economics, November 1978.

"The Effect of Social Security on Early Retirement" (with M. Hurd), Journal of Public Economics, August 1978.

"The Long-Run Incidence of Government Policies in Open Growing Economies" (with P. DeVille), in Economics and Human Welfare: Essays in Honor of Tibor Scitovsky, Academic Press, 1979.

"Economic Factors behind the Tax Revolt," National Tax Journal, October 1979.

"Interrelationships among the Choice of Tax Base, Tax Rates and the Unit and Time Period of Account in the Design of an Optimal Tax System," in The Economics of Taxation, Aaron and Boskin, eds., 1980.

"Social Security and Private Saving: Analytical Issues, Empirical Evidence and Policy Implications," (with M. Robinson), U.S. Congress, Joint Economic Committee, Special Study on Economic Change, 1980.

"The Impact of Inflation on U.S. Productivity and International Competitiveness," (with M. Gertler and C. Taylor), National Planning Association, 1980.

"Social Security: The Challenge Before Us," in P. Duignan and A. Rabushka, eds., The United States in the 1980's, Hoover Institution, 1980.

"Growth Policy for the Eighties," U.S. Dept. of Commerce Proceedings of the Workshop on Supply-Side Economics, 1980.

"Issues in the Taxation of Capital Income," (with J. Shoven), American Economic Review, May 1981.

"Some Issues in Supply-Side Economics," in K. Brunner and A. Meltzer, eds., Supply Shocks, Incentives and National Wealth, Carnegie-Rochester Conference Series on Public Policy, 1981.

"Taxation, Innovation and Economic Growth," in Technology in Society, Vol. 3, pp. 35-44, 1981.

"Federal Government Deficits: Myths and Realities," American Economic Review, May 1982.

"Modelling Alternative Solutions to the Long-Run Social Security Funding Problem," (with M. Avrin and Ken Cone), in M. Feldstein, ed., Behavioral Simulations of Tax Policy, University of Chicago Press, 1983.

"Optimal Tax Treatment of the Family," (with E. Sheshinski), Journal of Public Economics, April 1983.

"Effects of Budgetary Constraints and Budgetary Cuts," Proceedings: International Institute of Public Finance, Budapest, Hungary, 1983.

"A Longer Term Perspective on Macroeconomics and Distribution: Time, Expectations, and Incentives," in Issues in Contemporary Economics and Distribution, G. Feiwel, ed., The MacMillan Press, 1984.

"Concepts and Measures of Earnings Replacement During Retirement," with J. Shoven, NBER Conference Volume, J. Shoven and D. Wise, eds., Issues in Pension Economics, University of Chicago Press, 1987.

"The Effect of Social Security on Retirement in the Early 1970's," (with M. Hurd), Quarterly Journal of Economics, November 1984.

"Poverty Among the Elderly: Where Are the Holes in the Safety Net?," (with J. Shoven), paper presented at NBER Conference on Pensions and the U.S. Economy, Baltimore, MD, March 21-22, 1985, in Z. Bodie, J. Shoven, and D. Wise, eds., Pensions in the U.S. Economy, Univ. of Chicago Press, 1988

"Macroeconomics, Technology and Economic Policy," in R. Landau and N. Rosenberg (eds.), Technology and Economic Policy, National Academy Press: Washington, D.C., 1985.

"Changes in the Age Distribution of Income in the United States, 1968-84," with L. Kotlikoff and M. Knetter, NBER Working Paper, #1766, 1985.

"Economic Aspects of the Taxation of Decontrolled Natural Gas," with M. Robinson, National Tax Journal, June 1985.

"Public Debt and U.S. Saving: A New Test of the Neutrality Hypothesis," with L. Kotlikoff, in Carnegie-Rochester Conference Series, No. 23, Summer 1985.

"Deficits, Public Debt, Interest Rates & Private Saving: Perspectives and Reflections on Recent Analyses and U.S. Experience," in M. Boskin, J. Fleming and S. Gorini, eds., Private Saving and Public Debt, Basil-Blackwell, 1986.

"Indexing Social Security Benefits: A Separate Price Index For The Elderly? " (with M. Hurd), Public Finance Quarterly, Vol. 13, No. 4 October 1985.

"Energy Taxes and Optimal Tax Theory," with M. Robinson, The Energy Journal, September 1985.

"New Estimates of the Value of Federal Mineral Rights and Land," with M. Robinson et al., American Economic Review, December 1985.

"Theoretical and Empirical Issues in the Measurement, Evaluation and Interpretation of Post-War U.S.Saving," in G. Adams and S. Wachter, eds., Saving and Capital Formation: The Policy Options, Lexington Books/D.C. Heath, 1986.

"Retirement Income Support From the Private Sector," paper prepared for Joint Japanese/OECD Conference on Health Care and Pension Policies in the Context of Demographic Change and Economic Constraint, Tokyo, Japan 25-28 November 1985.

"New Estimates of Federal Government Tangible Capital and Net Investment," with M. Robinson and J. Roberts, in D. Jorgenson and R. Landau (eds.) Technology and Capital Formation, MIT Press, forthcoming 1989. Also in M. Boskin, The Real Federal Budget, Harvard University Press.

"Saving and Economic Growth in the United States: Policy Issues and Options, US Congress, A Symposium on the 40th Anniversary of the Joint Economic Committee, Jan. 16-17, 1986.

"New Estimates of the Effects of Taxes on the International Location of Investment," (with William Gale), in M. Feldstein, ed., The Effects of Taxation on Capital Formation, University of Chicago Press, 1987.

"Social Security: A Financial Appraisal Within and Across Generations, National Tax Journal, March 1987, with J. Shoven, L. Kotlikoff and D. Puffert.

"A Closer Look at Saving Rates In the United States and Japan," with J. Roberts, in John Shoven, ed., Government Policy Towards Industry in the US and Japan, Cambridge University Press, 1988.

"Social Security and the American Family," in Federal Tax Policy, ed. by L. Summers, 1987.

"New Estimates of the State and Local Government Capital Stock and Net Investment," with M. Robinson and A. Huber, NBER Working Paper #2131, 1986.

"Alternative Concepts and Measures of Federal Deficits and Debt and Their Impact on Economic Activity," in K. Arrow and M. Boskin (eds.), Economics of Public Debt, MacMillan for the International Economic Association, 1988. (NBER Working Paper, 1987)

"The Federal Budget and Insurance Programs," (with B. Barham, K. Cone and S. Ozler), in M. Boskin (ed.), Modern Developments in Public Finance, Basil Blackwell, Ltd. 1987.

"Perspectives on the Tax Reform Act of 1986," National Tax Association Annual Proceedings, 1986, published 1987.

"The Financial Impact of Social Security by Cohort," in E. Lazear and R. Ricardo-Campbell (eds.), Issues in Contemporary Retirement, Hoover Institution Press, 1988.

"Government Saving, Capital Formation and Wealth in the United States, 1947-1985," in R. Lipsey and H. Stone (eds.), The Measurement of Saving, Investment, and Wealth, The University of Chicago Press, 1988.

"Personal Security Accounts: An Alternative Social Security Reform Proposal," with J. Shoven and L. Kottlikoff.

"Future Social Security Financing Alternatives and National Saving," S. Wachter and M. Wachter, eds., Social Security and Private Pensions: Providing for Retirement in the 21st Century, Lexington Books, 1988.

"Tax Policy and Economic Growth: Lessons From the 1980s," forthcoming in Journal of Economic Perspectives, 1988.

"An Analysis of Postwar U.S. Consumption and Saving," with L. Lau, NBER Working Paper Nos. 2605 and 2606, 1988.

"Issues in the Measurement and Interpretation of Saving and Wealth," forthcoming in the 50th Anniversary Volume of the Conference on Research in Income and Wealth.

"Consumption, Saving and Fiscal Policy," American Economic Review, Vol. 78, No. 2, May 1988, pp. 401-407.

"Tax Policy and Economic Growth: Lessons From the 1980s", Journal of Economic Perspectives, Fall 1988.

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

Bush for President	1988	$1,000
Dole for President	1988	$1,000
Tom Campbell for Congress	1988	$1,000
Ed Schau for Senate	$2,000 , 1986, for Congress, 1984,	$1,000
RNC Presidential Trust,	1988	$1,000
Lincoln Club of No. California	1988	$1,000

Qualifications: State fully your qualifications to serve in the position to which you have been named.

(attach sheet) I believe my record in teaching and research as well as government consulting, qualifies me for this position.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

No, I will be on a leave of absence from Stanford University. I have severed my other connections; my subchapter S corporation will be inactive.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

Yes, I plan to return to Stanford University

3. Has anybody made you a commitment to a job after you leave government?

No

4. Do you expect to serve the full term for which you have been appointed?

Yes

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

None

3. Describe any business relationship, dealing or financial transaction (other than tax-paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None. I have testified on public policy issues and served as a consultant to Congressional committees in my capacity as a professional economist, (e.g. the House Ways and Means Committee in 1985 on Tax Reform-testimony, retreats at Patrick Air Force Base and Airlie House and 1988 in Gallinsburg)

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

I do not believe any exist. If one were inadvertently overlooked, I would sever any relationship that might be construed in any way as posing a potential conflict.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

RESPONSES TO SENATOR RIEGLE'S PRE-HEARING QUESTIONS

1. Despite the apparent prosperity of the last several years, the competitive positions of most American industries have continued to erode, and with them our relative standard of living.

A. Before I respond to your specific questions I would like briefly to put the U.S. trade position in perspective. We most certainly have a large trade deficit that should and will be reduced. However, it is important to recognize that the bulk of that deficit was not mainly related to unfair trade practices. Rather, it primarily was the result of several major trends that have now been reversed, and as a result the trade deficit is being reduced.

The increase in the trade deficit and the high value of the dollar in the early to mid-1980s can be attributed to several interrelated factors, including the strength of the U.S. economy and domestic demand relative to other countries, the debt problems in less developed countries, the attractiveness of investment in the United States, and the low level of U.S. saving relative to investment.

Since 1985, other countries' improved performances and their domestic demand growth have accelerated while U.S. domestic demand growth has slowed. These factors and the depreciation in the dollar, coupled with increases in U.S. manufacturing productivity and wage restraint, have led to a significant improvement in the competitive position of U.S. firms. Since their peaks the deficits in real and nominal net exports have fallen 38 and 36 percent, respectively. Further reductions in the Federal budget deficit will raise national saving and take some pressure off the trade deficit.

Also, it is important to bear in mind that the United States is no longer at a major overall competitive disadvantage. OECD estimates indicate unit labor costs in U.S. manufacturing relative to other countries are now lower than they were in 1980. The United States continues to have the highest standard of living and productivity of any major industrialized nation. Japanese productivity, for example, is only 70 percent of U.S. productivity. While other nations' real GNP per capita and productivity have moved over the past few decades toward U.S. levels, this trend reflects the "catching-up" of other nations to the United States after the devastation of their economies during World War II. Since 1983 the United States has outperformed the OECD-Europe by a considerable margin. Only Japan and Canada have performed as well.

Q. What is the most appropriate approach to negotiating our trade relations with major surplus countries that restrict imports from the U.S.?

A. Trade policy should reflect a vigorous commitment to opening foreign markets. The desirablity of removing foreign barriers to U.S. exports is not limited to those countries that have a bilateral surplus with the United States. The potential benefits to the United States from eliminating these trade distortions are just as important for those countries that run overall trade deficits as for those that run trade surpluses.

The current Uruguay Round of GATT negotiations is the most appropriate framework for obtaining the negotiated reduction in foreign trade barriers. There are very large potential gains to the United States, and the world economy, from achieving progress in our major goals of reform of world agricultural policies, extension of trade liberalization to services, and enhanced international protection of intellectual property rights for example.

Since not all issues can be addressed in a multilateral context, the United States should continue to pursue, via bilateral consultations, elimination of foreign barriers that are detrimental to the U.S. economy. It is also important that U.S. trade policy be conducted in a coordinated fashion, so that these bilateral efforts reinforce, rather than undermine, our multilateral efforts.

Q. What specific policies can we adopt to enhance the U.S. saving rate and channel those savings toward productive investment?

A. Let me make a few comments to place recent saving and investment behavior in perspective before I discuss policy options. Real nonresidential fixed investment as a share of GNP during the 1980s is above its postwar average. Real nonresidential fixed investment accounted for 11.6 percent of GNP in 1987 and 12.2 percent in 1988, well above the averages in the 1960s and 1970s. While personal saving out of disposable personal income has fallen since the 1970s, and government dissaving has risen, by other, perhaps more inclusive measures, the decline has not been so precipitous.

We are also beginning to see adjustments taking place. The Federal budget deficit has fallen from 5.4 percent of GNP in fiscal year 1985 to 3.2 percent in fiscal year 1988., With appropriate budget policy, the deficit will continue to decline. On the household side we have also seen improvement. The rapid rise in household net worth during the 1980s reduced household saving out of current income, but since the October 1987 stock market decline household saving has increased. I also anticipate further improvement in the saving rate as the baby-boom generation moves past its peak consumption years.

The best approach to increasing the national saving rate is to reduce the Federal budget deficit in a manner that does not reduce private saving. At the same time, from the viewpoint of total productive investment, budget policy should recognize the potential importance of government investment in research and development, tangible capital, and education.

The maintenance of a low and steady inflation rate and further progress toward price stability is one essential ingredient to enhance the U.S. saving rate. Other policies that are worthy of consideration are a lowering of the capital gains tax and changes in those tax rules that may discriminate against equity in favor of debt. In general, private markets are the most efficient means of channeling private savings into their most productive uses. Government policies designed to promote certain industries at the expense of others or to steer savings toward certain investments -- in short, the government picking winners and losers -- have not been very successful in the past, either in the United States or abroad. In fact, such policies have proved quite harmful in some countries.

Q. What role should government play in formulating an overall competitive response to the global challenges faced by our

vital industries?

A. The government's primary role in maintaining America's competitiveness is to create an environment that nurtures the inherent creativity and productivity of American workers and entrepreneurs. We must maintain a stable, low-inflation macroeconomic environment that facilitates investment, productivity growth, and long-term planning. We must avoid unnecessary regulations and paperwork that waste resources and stifle innovation, and we must minimize export restrictions. We should carefully evaluate the consequences of mandated benefits that raise U.S. costs and reduce employment opportunities and competitiveness. The government should maintain and consider enhancing its role in funding basic research, and should ensure that incentives exist for the results to be made available to U.S. industry.

Some foreign countries distort international trade and production patterns through a variety of unfair practices, including export and production subsidies, and visible and invisible barriers that restrict imports. These practices provide unfair advantages to foreign producers, hurt U.S. firms and workers and undermine support for an open and fair trading system. These foreign barriers to U.S. exports must be eliminated, as should foreign unfair trade practices that threaten domestic industries. Opening foreign markets to U.S. exports is the most effective way to promote U.S. industries which can benefit from foreign sales. Protectionist policies in the United States tend eventually to undermine these same industries by raising the costs of important inputs, by reducing the competitive pressure for innovation and by risking retaliation from abroad.

2. Our financial markets and banking systems have been dramatically transformed by the increasing proportion of our debt (and equity) securities held abroad, by the globalization of banking systems and merchant banking activity, by the securitization of many financial contracts formerly held privately by intermediaries, and the invention of new securities and swaps which transfer risk across the system. In light of this:

Q: How must the implementation and the effectiveness of monetary policy change?

A: According to the Federal Reserve, the goal of monetary policy is to achieve price stability in an environment of sustainable real output growth. The Federal Reserve attempts to achieve this goal by targeting the growth of the monetary aggregates. These financial market developments can make the Federal Reserve's task of implementing its policy more difficult if they disturb the historical relationships between the growth of reserves of depository institutions and money growth or between money growth and inflation. However, the Federal Reserve can adjust as it learns about the impacts of these developments, so these developments will have only a temporary impact on the implementation and effectiveness of monetary policy.

Q: In what directions should the structure of the U.S. banking system be encouraged to evolve?

A: To maintain its leadership role, the U.S. banking system will need to be able to compete effectively with foreign institutions in this changing environment. U.S. banking institutions should be permitted to take advantage of the opportunities provided by these global trends.

Q: How should the structure of banking regulatory authorities and their policies change to keep pace with this transformation?

A: The basic structure of banking regulatory authorities appears to be sound. Some changes may be needed, however, to allow banking institutions to compete more effectively, subject to appropriate restrictions to assure safe and sound operations. Gradual changes may also be appropriate in the structure of bank capital requirements so as to reflect both the risks and risk-diversification opportunities presented by the new global environment.

Q: How should the regulators of financial markets (the SEC and CFTC for example) change to similarly keep pace?

A: The new global environment also greatly expands the investment options available to securities and commodities firms. It may consequently also be appropriate for the SEC and CFTC to review and where necessary to modify their regulatory roles. The Administration is actively studying these issues.

3. The aggregate debt loads of virtually all sectors of our economy (households, corporations, and the Federal Government) have soared in recent years.

Q: Does the rising outstanding debt of the Federal Government threaten to siphon off savings and impede private capital formation?

While public and private debt have been growing, and for certain sectors debt levels present real problems, overall debt has not reached levels that call for sweeping changes. The growth in assets has exceeded the growth in debt and therefore, household (and national) net worth has continued to increase in recent years. Corporate debt-equity ratios, when assets are valued at market prices rather than historical book value, are well below the peak levels of the mid-1970s. Also, corporate net interest payments as a percentage of cash flow are rising but are below the peak levels of the early 1980s. Finally, the ratio of the Federal net debt to GNP, at 43 percent, has stabilized and is projected to decline gradually.

The strong growth in business investment in the past few years would suggest that the Federal Government budget deficits of this expansion period have not significantly impeded private capital formation. Capital inflows from abroad, which have been attracted by our relatively stable political environment and attractive returns on capital, have partially offset the dissaving by the Federal Government. This does not mean we can continue to run deficits indefinitely. We must continue to reduce the deficit steadily.

Q: How should regulatory policies respond given the increasing vulnerability of our banking system to third world debt, LBO debt, and other high risk lending?

A: Responses to increases in exposure should consider the events and incentives that created the increases. In this way we can guard against short-run solutions which do not simultaneously address long-run problems.

The decision by a bank to undertake a loan should reflect all relevant risks. Federal guarantees not accompanied by adequate regulatory oversight may encourage banks to engage in unduly risky lending activities. Tax laws that encourage debt financing may work to increase the debt holdings of banks, and should be reviewed.

In addition to addressing these fundamental questions of incentives, authorities responsible for supervising banking institutions should maintain in force those policies which now prevent such institutions from making loans to any

single borrower who exposes an excessive proportion of their capital to loss. In addition, regulatory authorities should impose capital requirements adequate to cover foreseeable losses, and must diligently monitor banking institution compliance with such requirements.

Regulatory policy toward private bank lending to developing countries should make clear that the taxpayer will not bear the burden of potential problems. The policy should facilitate voluntary negotiations between creditors and debtors in cases where debt servicing has become problematic. An environment conducive to innovative, voluntary solutions -- debt-equity swaps, debt-buybacks, etc. -- should be encouraged. Regulations making such responses more costly or more difficult for the banks should be avoided when possible. Since the conditions in each developing country differ, the policy must recognize diversity and avoid plans which invite countries to take excessive risks and ultimately compound their debt problems.

It is important not to overreact to increasing debt loads or risky debt portfolios. Open capital markets benefit both borrowers and lenders. Regulation should be directed toward improving the incentives of bankers, bank stockholders, and bank depositors to make full appraisals of the risks, and toward encouraging the parties to take prompt action in cases of difficulty.

Q: What new public sector initiatives do we need to monitor and respond to the particular risks posed by "junk bonds" and other publicly-traded, high-risk securities?

A: It is not clear that the particular risks posed by higher-risk debt securities call for any new public sector initiatives. However, the issue clearly requires study. We must consider carefully the pattern of and reasons for the rise in LBOs and the potential impact on the economic system.

The tax system does encourage the substitution of debt for equity, but we must proceed carefully in this area. We do not want to lower U.S. competitiveness and investment by imposing rules that raise U.S. corporations' costs of capital through restrictions on the deductibilty of interest on debt. We may, however, want to consider some change in the treatment of equity relative to debt -- most of our major competitors provide relief from the double taxation of dividends -- but given current budget constraints such a move must be considered carefully.

Q: Has our entire financial system become more fragile and, if so, what changes in the relationship between government and

private institutions and markets does this suggest?

A: With the exception of certain parts of the thrift sector, the U.S. financial system appears to be in good health. In the last several years, banks have increased their loss reserves and improved their profitability. Nevertheless, we should look carefully at opportunities for enhancing competition among financial institutions, and at possible revisions of oversight mechanisms.

4. Many of our thrift institutions have had great difficulty in recent years adapting to the problems of fluctuating interest rates and the opportunities of new and expanded powers.

Q: What changes are necessary in the regulatory authorities that supervise thrifts?

A: Institutional changes in the structure of the thrift regulatory authority merit further study. For example, separating the insurance from the chartering and oversight functions may be desirable. Changes in regulatory policy to provide the proper management incentives for thrift institutions also may be needed. For example, thrift institutions should be encouraged to operate with more adequate capital. To the extent that undercapitalized institutions are able to continue to operate with the FSLIC bearing most or all of the downside risk of their investment decisions, the contingent liability of the FSLIC will likely continue to grow.

Q: Should we embark upon a process of re-regulating thrifts as special purpose home financing institutions?

A: Thrifts will continue to play an important role in home financing. Their participation in other lending activities now open to them potentially allows for risk reduction through diversification, and enhances competition in the market for financial services. However, as noted above, the monitoring and capital required for these activities must be appropriate.

Q: Or should thrifts continue to expand their powers so as to become indistinguishable from other deposit institutions?

A: The financial services industry is clearly characterized by a worldwide trend toward a structure of institutions which each engage in a diversified range of financial activities. Such a trend is a consequence of the advances in computerization and communication, and has resulted in gains to consumers and more efficient resource allocation. Thrift institutions, as well as other financial institutions, will need to adjust to these global forces.

RESPONSES TO SENATOR GRAMM'S PRE-HEARING QUESTIONS

Q. What are the maximum likely annual debt service benefits to be gained from the forgiveness of as much as one-third of the debt of troubled Third World debtors?

A. A precise estimate of the short-run interest cost saving to developing debtor nations would require substantial study because of the wide range of debt levels, contracts, agreements, and interest rates involved in developing country loans. According to World Bank projections, the debt service-to-GNP ratio of 17 highly indebted countries will average around 10 percent in 1988. As a very rough estimate, forgiving one-third of the debt would therefore in the short run reduce the debt service ratio to about 7 percent; but forgiving that debt would set in motion a variety of forces affecting the availability of capital, interest rates, and other factors which may prove detrimental in the long run. These effects would depend in part on the conditions under which this hypothetical one-third debt forgiveness occurred.

Banks have recently taken steps to increase their loss reserves and are in the process of raising additional capital. They are moving to reduce their exposure by exchanging current debt for equity, debtor bonds, and other local claims at market or negotiated prices. We should continue to support these voluntary negotiations.

Q. To what extent are the debt problems of certain Third World countries attributable to policies and conditions in these countries that discourage direct investment by foreign investors?

A. The developing nations' debt problems arose for different reasons in different countries. A major factor was the low, sometimes negative, real interest rates in the high-inflation 1970s which led many countries to take on large amounts of debt, much of which was denominated in dollars. In the 1980s the price of oil and many basic commodities fell, cutting export earnings for some countries at a time when a high dollar and high real interest rates greatly raised debt service costs. Mismanagement of investment projects also played a role in some instances.

However, capital controls, high inflation, nationalization of private enterprises, state-fostered monopolies, excess regulation and poor economic growth have handicapped recovery in many of these countries. These policies and conditions have discouraged foreign direct investment and encouraged capital flight. Recent IMF estimates indicate that the flight capital from seven highly indebted countries may be as large as one-third the size of their external debt. Deprived of

essential investment resources these countries' current and future growth is at risk.

Q. What steps do you believe that the United States can and should take to promote free enterprise and reduced government involvement in the economies of third world countries?

A. The chief aim of the United States should be to continue to support developing nations' prospects for lasting economic reforms and sustainable growth. We should continue to encourage policies oriented toward trade and financial market liberalization, privatization, deregulation, increased reliance on market prices including exchange rates, fiscal balance, and noninflationary monetary policy.

Q. What costs to the U.S. economy would result from increased disincentives to foreign investment in the United States?

A. Foreign investment makes an important contribution to the U.S. economy. By helping to build productive plant and equipment in the United States, foreign investment contributes to current and future increases in jobs, productivity, and growth. Open international credit markets benefit the United States and all nations.

Concerns about foreign ownership are somewhat exaggerated. By the end of 1987, measured net foreign assets in the United States amounted to some 3.1 percent of U.S. net wealth on an historical cost basis. Moreover, the U.S. direct investment position abroad continues to exceed the foreign direct investment position in the United States.

RESPONSES TO SENATOR MACK'S PRE-HEARING QUESTIONS

1. The problems of the savings and loan industry will obviously be discussed in great detail by this Committee in the coming months. Most people seem convinced that any solution must include a taxpayer bailout of the deposit insurance system.

But to a significant degree, Congress is responsible (at least indirectly) for the problems of the S&L industry. Congress has presided over the existing misconceived regulatory system for a number of years. It is widely recognized that our present deposit insurance system creates severe disincentives for prudent management of savings and loans.

Q. Under these circumstances, I'm not sure that it is proper to ask taxpayers to pay for the mistakes of the Federal Government. But that notwithstanding, how do we change the institutional framework so that in the future the savings and loan industry is less encumbered and damaged by Congress and its regulatory influence?

A: Institutional changes in the structure of the thrift regulatory authority merit and are receiving further study. For example, separating the insurance from the chartering and oversight functions may be desirable. Changes in regulatory policy may also be needed to provide the proper management incentives for thrift institutions. For example, thrift institutions should be encouraged to operate with more adequate capital. To the extent that undercapitalized institutions are able to continue to operate with the FSLIC bearing most or all of the downside risk of their investment decisions, the contingent liability of the FSLIC will likely continue to grow.

2Q. Is there an economically viable way of financing a recapitalization of FSLIC that does not include a massive transfer of money from taxpayers?

A. The government has incurred an obligation under FSLIC. Estimates of the magnitude of the obligation vary widely, but recent estimates are in the range of $75 to $100 billion, some portion of which has already been covered. It is possible to raise the additional funds in a variety of ways. The Administration is currently studying the problem carefully and analyzing alternatives.

However the funds are raised to address this problem, it is important to recognize that time is of the essence. If we do not deal constructively with insolvent thrifts in a timely manner, the problem may get worse.

3Q. The crisis of Latin American debt, and third world debt in general, could pose severe problems for the United States. I am convinced that this crisis would have been much less severe, or perhaps not even occurred at all had free markets and capitalism been given a looser reign in these countries. What economic policy measures can the United States take to increase the viability of capitalism in these countries?

A. In many developing countries the prospects for sustainable growth can be enhanced by economic reform, including a greater reliance on free markets and capitalism. Capital controls, high inflation, protectionism, and the nationalization of private enterprises have handicapped these countries in their efforts to recover during the 1980s, and in some cases have exacerbated the problems by inducing capital flight. The economic policies of many developing countries discourage both foreign and domestic investment. The United States should continue to encourage trade and financial market liberalization, deregulation, privatization, reduced marginal tax rates, and increased reliance on market prices including exchange rates. Such policies can foster economic growth and assist these countries to return as reliable participants in world credit markets.

4Q. Because of the turmoil in Central America, U.S. border states (and Florida in particular) are experiencing a large influx of refugees. This, of course, poses considerable housing problems for communities in these states. What sort of minimal-government, market-oriented initiatives, such as enterprise zones, would you suggest to provide housing and other services for these refugees?

A. I understand your concerns about the problems certain states face in absorbing immigrants. I also appreciate your interest in finding market-oriented solutions that minimize the involvement of the government. The question of assuring that immigrants have access to adequate housing and other services involves a number of complex issues.

The requirements of the U.S. Government for legal immigration assure some degree of financial responsibility. Most legal immigrants are immediate relatives of U.S. citizens or receive a preference on the basis of occupation. For refugees fleeing political persecution, the State Department works with private voluntary organizations to provide resettlement assistance, including shelter and employment.

The availability of housing and other services for immigrants depends on the same factors that determine their availability to the native-born. Aside from resettlement assistance for political refugees, there are no special Federal Government programs for providing housing for immigrants as such.

The United States has an outstanding record of successfully absorbing immigrant labor. Most of the foreign-born enter the labor force. The employment-to-population ratio of recent arrivals is higher than that of the native-born. Even illegal immigrants use market opportunities to improve their economic status and work themselves up from entry-level jobs.

I see the issue of providing housing and services to immigrants as part of the broader issue of assuring that all members of society have the opportunity to participate in the economy. The merits of such initiatives as enterprise zones need to be assessed based on their contribution to the community as a whole, not just to the foreign-born.

Responses to Written Questions Submitted by Senator Riegle

Q1. A number of noted economists (Schultze, Aaron, etc.) believe that the large build-up in the Social Security reserves is an important way to increase the national savings rate. Do you agree? What do you think should be done to make sure the Social Security reserves are saved and not spent on other government functions? Do you support removing Social Security surpluses from the calculation of the Federal deficit under the Gramm-Rudman-Hollings balanced budget law?

A. The build-up of the Social Security Trust Fund can contribute to an increase in the national savings rate. Improved budgeting procedures and rules can help make sure that the Social Security Trust Fund's surpluses are not spent on other government functions. Congress can play an important role in the process of preventing the Social Security Trust Fund reserves from increasing government spending. At this time I do not support removal of the Social Security Trust Fund from the calculation of the Federal deficit under the Gramm-Rudman-Hollings balanced budget law. The best measure of the impact of the Federal budget on credit markets and the overall economy is given by the unified budget deficit and changes therein. There are also some technical problems with removal of the trust fund from the unified budget. These technical problems result in overstatement of the trust funds surplus by including intragovernment transfers as income to the trust fund. These intragovernment transfers consist mainly of government interest transfers to the fund and government FICA credits for Federal workers. As we meet the GRH target for a balanced unified budget in 1993, the issue of the contribution of the Social Security Trust surpluses to national saving should be studied and its treatment in the budget reassessed.

Q2. In your book <u>Too Many Promises: The Uncertain Future of Social Security</u>, you proposed a radical overhaul of social security which would replace it with a two-part system: one part, a means-tested welfare program, and another more like a pension system, with benefits closely linked to contributions.

Have your views changed, or would you be advocating similar changes in Social Security as Chairman of the President's Council of Economic Advisers?

A. Currently, there are two parts--the second being SSI for the low-income elderly. The 1983 Social Security amendments plus the decision last year of the SSA to provide more comprehensive information to prospective retirees earlier alleviated much of the concern expressed in my previous

writings on Social Security. However, by moving us away from pay-as-you-go finance, the 1983 amendments also raised the issues discussed in question 1.

I will not be advocating such changes in Social Security as Chairman of the President's Council of Economic Advisers. The system of government financed social security serves many useful purposes and it is not in the national interest to make major changes in it in the foreseeable future.

Responses to Questions by Senator Sanford

Q: The Federal Debt at the end of FY 1988 was $2,601 trillion, and is estimated to increase $268 billion during FY 1989. With most favorable estimates of revenues, cuts, interest rates, growth, and in spite of reductions of annual deficits, the projections are that President Bush's last budget to be submitted in this term, FY 1993, will carry the Federal debt just short of another trillion dollars, to $3,720 billion.

A: In examining trends in the Federal debt it is important to distinguish between gross and net debt. A large portion of the gross Federal debt is held in Federal Government accounts (such as the Social Security Trust Funds) and by the Federal Reserve. At the end of 1988 the gross Federal debt was $2.6 trillion. Just as the unified budget deficit reflects the offsetting surplus of the Social Security System and the profits of the Federal Reserve, the net Federal debt reflects the offsetting purchases of debt by Federal agencies and includes only the debt held by the public. As of the end of 1988 the net debt was $2.1 trillion which amounted to 42.9% of GNP that year. (The ratio of debt to GNP is a rough measure of the size of the debt relative to the Nation's ability to pay). Although the gross Federal debt is projected to rise to $3.9 trillion in 1994 based on OMB projections, the net Federal debt held by the public is projected to fall relative to GNP. A large part of the growth of the gross Federal debt will come about as a result of Social Security Trust Funds surpluses. Based on OMB projections the net Federal debt held by the public in 1994 is forecast to be 34.1% of GNP as progress is made toward reducing the deficit.

Q: What are the effects, harmful or beneficial, of our owing a debt of this size?

A: The effect of debt on the economy depends on how the funds are used and on how it affects private saving and investment. Financing current Federal expenditure by issuing debt involves postponement of taxes to the future. Increases in the Federal debt imply that tax payments are transferred from current to future taxpayers. There are advantages to debt finance when it is used to fund government investment such as infrastructure that provide benefits that will offset future taxes. The disadvantages of a growing Federal net debt include the fact that it implies that the government sector is absorbing saving, which could adversely affect capital formation. In addition to these economic factors, there is a moral or ethical dimension as well: we should not be leaving larger (relative to income) public debt to our children unless we also leave them larger assets, public and/or private. We

especially should not leave larger relative public debt and smaller private assets, if the deficits crowd out private investment by Americans.

Q: Do you think the debt is a problem that should receive priority attention from the Administration.?

A: Yes. The only way to reduce the rate of growth of the Federal debt held by the public is to reduce the Federal budget deficit. Controlling the rate of growth of outlays will reduce the deficit.

Q: Can our reasonably good economy be attributed to our tremendous deficits? Can the economy prosper if we start reducing the debt?

A: The economic expansion of the 1980s cannot be attributed to Federal budget deficit. The economy is a complex mechanism and no one cause can be singled out for its good performance. Factors that probably contributed to the good U.S. economic performance were the reduction in inflation, improved economic incentives through lower tax rates, deregulation, and the flexibility of our labor markets. The deficit's net impact over the course of the expansion may have been to absorb private saving and reduce investment somewhat. However, the negative effect of the budget deficit on saving and investment has been partly offset by increased foreign investment in the United States.

Reducing the Federal debt will not adversely affect the performance of the economy. If a major budget agreement is reached I, as well as most economists, believe interest rates will fall, encouraging private investment and increases in productivity.

Q: Can we recover our foreign trade deficit without reducing our debt that now requires borrowing foreign funds?

A: First, it is worth noting that foreigners voluntarily purchase our debt and invest in the United States. They do so partly because the United States is a large and growing country that provides them with a relatively safe and high rate of return on their investment. The fraction of our national debt held by foreigners is still modest. To the extent that foreign funds have financed higher U.S. investment, they have added to our productivity and employment.

While reducing the Federal debt and deficit could help to reduce the U.S. trade deficits, reduction of the Federal debt is not necessary to reduce our foreign trade deficit. The United States incurs trade and current account deficits

whenever U.S. investment and consumption expenditures, including government expenditures, exceed U.S. output. The difference between U.S. demand and production is made up by increased imports. Reducing government expenditures can help reduce the trade deficits while simultaneously reducing the annual Federal budget deficits and government borrowing from abroad. Reduction of the trade deficit can also come from a number of other sources, such as the increase in foreign demand for U.S. products, such as we have seen in recent years, and an increase in the household saving rate such as during the last year. Reducing the trade deficit does not depend on the United States running government budget surpluses, which would be required to reduce the outstanding government debt, measured in current dollars.

Q: If you agree that debt growth should be curtailed, or debt should be reduced, what action would you propose?

A: The growth of the Federal debt should be curtailed. This can be accomplished by reducing the Federal budget deficit. The Administration proposes to accomplish this by reducing the rate of growth of Federal spending.

Q: Is there an ideal range of total debt we should seek?

A: There is no ideal ratio of debt to GNP. Numerous examples can be shown of countries, including the United States, that have shown excellent economic growth with debt burdens far higher than the current ratio. The real issue for long-term growth is the debt's impact on capital formation. If private saving and investment are strong or the debt is used to finance truly productive investments in public infrastructure, increases in productivity, income, and wealth will provide the funds to service the debt. The current concern arises because private household saving is low and the bulk of Federal spending is for consumption rather than investment.

2. Budget deficits are shown (Table 1.1, "Historical Tables," Budget of the United States Government) to be $155 billion for FY 1988 (in contrast to a real increase in the Federal Debt of $251 billion), regularly diminishing until in FY 1993 a surplus of $2 billion is shown. This is in contrast to a real increase in the Federal Debt for FY 1993 of $178 billion.

Q: When, and if, the annual deficits are eliminated, the debt will continue to grow, astronomically, some would say. Is there something we can do now to avoid this? Should we?

A: Eliminating annual Federal deficits will stabilize the net Federal debt held by the public and slow the growth of the

gross Federal debt. Also, the burden of the debt will be smaller than the nominal figures indicate. For example, the debt held by the public will decrease in real value due to inflation. Measured relative to GNP, the rate of growth even of the gross Federal debt will slow substantially.

Q: We know we can reduce the paper deficits by accounting and Gramm-Rudman-Hollings devices. How can we reduce the debt --or even stop its growth -- in the next 4 years?

A: The net debt held by the public will be reduced in 1990 as a percent of GNP and will continue to be reduced as we control growth of Federal outlays. The gross debt will continue to grow in the future along with increases in the Social Security surpluses. (The net debt held by the public which excludes these surpluses will fall as a percent of GNP). This increase in liabilities represents claims by future retirees. The increase in these claims will not be a source of concern as long as we continue to slow the growth of non-Social Security spending so that the Social Security surpluses can be used to raise investment, productivity, and incomes. If this tangible investment occurs, the increase in the paper liabilities will be covered by real assets.

Q: What accounts for the wide disparity between the growth in the debt versus our annual deficits? Specifically, what accounted for the disparity of $94 billion in the FY 1988 budget?

A: As reported by OMB the FY 1988 deficit was $155.1 billion. (I refer you to Special Analyses, 1990 Budget of the United States, page E-9, to see that except for some minor adjustment, the growth of the net Federal debt held by the public is equal to the $155.1 billion deficit.) The disparity you mention is the difference between the net and the gross debt. Growth in the gross public debt is greater than the deficit because the Treasury provides government trust funds, such as the Social Security trust funds, with special issue securities that increase the gross but not the net indebtedness of the Federal Government.

Q: Is this honest accounting?

A: The accounting for the growth of the debt is both technically correct and honest, and accurately reflects the current and near-term net macroeconomic effect of Federal programs on the budget. On and off budget receipts and gross and net debt are both presented in the Budget tables relating to the deficit and the debt.

Q: Can it be refuted that we are financing the ongoing functions of government by using these regressive taxes?

A: First, I think it is important to look at both benefits and costs when assessing the distributional impact of the Social Security system. Although the payroll tax is considered regressive, if benefits are taken into account the total system appears to be progressive. Social Security benefits have been extremely important in reducing the poverty rate among the elderly.

Second, although a portion of these payroll tax revenues is used to invest in U.S. Treasury obligations that can be used to finance the non-Social Security deficit, the overwhelming bulk of this contribution goes to financing Social Security benefits. Finally, as long as over time the Social Security surpluses cause national saving and investment to be higher than they otherwise might be, the resulting increase in output and national wealth will help to increase the tax base from which benefits to future retirees will be paid. Thus, I agree with the General Accounting Office (GAO) in highlighting the importance for this issue of increased saving and investment.

Q: When these surpluses are needed in the future, where would you propose the government get the taxes to pay the debt to the Social Security Trust accounts?

A: The Social Security Trust funds are projected to be in surplus until the first quarter of the 21st century. After that time projections by the Treasury and the Social Security Administration indicate the Trust Funds will be in deficit. Policies that encourage private saving and growth in investment and productivity can increase real GNP and the tax base. This will minimize the necessity of tax increases or reductions in government spending to finance retirement benefits to a growing number of retirees as the second half of the 21st century is approached.

Q: Most people think their Social Security taxes are being squandered; do you disagree? How can those presently paying be reassured?

A: The fact is that the bulk of Social Security taxes paid finance benefits to current retirees today. The system is still a tax-financed retirement plan and analogies between Social Security and fully-funded retirement plans are highly misleading. I do not believe that FICA taxes are being squandered. The real issue in dealing with Social Security is to pursue policies that increase national saving so that economic growth will provide future taxable resources to finance future retirement benefits.

Q: In good times, should we desire a pay-as-we-go budget?

A: If you mean a budget in which there is neither a surplus nor a deficit, then I would answer you by saying that there are times in which a budget surplus would be desirable and other times when a deficit might be desirable. The current deficit levels are too high and their reduction is a top priority of this Administration.

Responses to Written Questions Submitted by Senator Garn

Q1. There appears to be a substantial disagreement among economists and other commentators as to the efficiency and productivity gains attendant to highly leveraged corporate restructurings. Have you reached any conclusions in this regard, and if so, what are those conclusions? Are you aware of any empirical studies that either support or dispute the notion that highly leveraged companies are more efficient and productive?

A. I have not reached any definite conclusions as to whether highly leveraged corporate restructurings, on average, enhance efficiency and productivity. Any conclusions reached as to average effects, of course, would not necessarily be applicable to any particular restructuring or class of restructurings.

There are a number of empirical studies which attempt to determine the source of the gains in per-share equity values that generally are associated with a highly leveraged restructuring. These studies seek to resolve whether those gains stem from efficiency and productivity gains, or instead reflect only tax savings or redistribution of wealth from other corporate stakeholders such as bondholders, employees, or retired employees. While those studies generally show that wealth redistribution effects account for at most only a small portion of the gain in equity values, they are inconclusive as to whether the gains derive primarily from efficiency or productivity gains, or instead primarily from tax savings. Some event studies suggest that leveraged restructurings generally result in efficiency gains. On the other hand, studies based on line-of-business data cast some doubt upon this conclusion.

Q2. Similarly, what is your professional judgement as to whether there have been net job losses or gains associated with highly leveraged corporate restructurings? Again, is there any empirical data in this regard? It would seem that when a company significantly increases its debt load in a financial restructuring then it must either sell off assets to reduce debt to manageable levels or significantly retrench its operations in order to reduce expenses to service the debt load. This would suggest job losses. Please comment.

A. It is difficult to determine whether net job losses or gains are associated, on average, with highly leveraged restructurings. Such a determination would have to involve consideration not only of the job losses or gains of the restructured companies, but also any job losses or gains in the rest of the economy that can be attributed to the

resource reallocations that stem from the restructurings. Such macroeconomic employment impacts of restructurings, while possibly substantial, are very difficult to isolate from the employment changes resulting from other economic factors. The empirical data on this issue is inconclusive. Any conclusion reached, of course, would not necessarily be applicable to the employment effects of any particular restructuring or class of restructurings.

A second difficulty encountered in evaluating the employment effects of restructurings is in defining the appropriate employment "baseline," since upon occasion substantial employment changes would have occurred even in the absence of a restructuring.

A company that significantly increases its debt load may, as you suggest, have to either sell off assets to reduce its debt load, or retrench its operations in order to reduce expenses to service its debt load. However, a leveraged restructuring may also be accompanied by more efficient managerial operation--and consequently increased earnings--which will enable the firm to service its higher debt load without any asset sales or retrenchments. Moreover, even if a firm does reduce its net employment after a leveraged restructuring, the overall long-term macroeconomic employment effects of the resource reallocations attributable to the restructuring may be an increase in total employment, even after allowing for the net employment reduction by the restructured firm.

Q3. The current success rate of leveraged corporate restructurings must be viewed in the context of a significant period of economic expansion and a continuing bull market. While acknowledging that it is not the policy of the Bush Administration to encourage any economic downturn, should such a downturn occur, is it your professional judgment that the companies involved in leveraged corporate restructurings would have sufficient cash flow to service their debt load, especially the approximately 40 percent of companies which are not in the non-cyclical, non-durable goods manufacturing sector? Is there any empirical data in this regard, and if not, do you intend to have the CEA develop these data?

A. Leveraged buy-outs continue to be a source of concern for the public, Congress and the Administration. Yet, it is important to put this issue in perspective. In 1987, LBOs represented approximately 20 percent of the value of all mergers and acquisitions, which is a relatively small fraction of total activity. One of the principal concerns that is expressed about LBOs is that highly leveraged firms would not be able to weather a severe economic downturn. Unfortunately, we have very little data at this point to

support or refute this contention. I have encouraged the CEA staff to gather data on this issue and keep me abreast of the most recent research findings.

Responses to Written Questions Submitted by Senator D'Amato

Q1. On Wednesday, Fed Chairman Greenspan testified that he believed that we risk unacceptably higher inflation if the GNP growth rate exceeds 3 percent. Mr. Darman of OMB has indicated that the Bush budget will likely adopt the assumption in the Reagan budget of 3.5 percent growth. Obviously Chairman Greenspan and Mr. Darman disagree. Do you have an opinion as to a sustainable level of GNP growth?

A. Any estimate of sustainable, trend, or potential GNP growth must exclude the effects of factors which temporarily increase or decrease growth. One such factor is last year's drought. The Commerce Department currently estimates that the drought temporarily lowered real GNP growth last year about 0.6 percentage point on a fourth-quarter-over-fourth-quarter basis. Assuming normal weather patterns return this year, real GNP growth will be boosted temporarily by about this same 0.6 percentage point as farm output returns to a more normal level. Excluding the effect of the drought, the 1989 real GNP forecast embodied in the 1990 Reagan budget is only 2.8 percent on a fourth-quarter-over-fourth-quarter basis, slower than the drought-adjusted 3.3 percent growth of last year and slower than Chairman Greenspan's 3 percent estimate. (Note: When the 1990 budget projections were established, the estimate of the drought's impact on 1988 real GNP growth was 0.7 percentage point.)

Estimates of a sustainable rate of real GNP growth are far from certain. Chairman Greenspan has testified that he believes that the sustainable rate of real GNP growth is likely to be somewhere between 2-1/2 and 3 percent. He also indicated that there is substantial uncertainty over whether productivity growth will rise in the intermediate term, thus allowing real GNP to grow at over 3 percent per year without accelerating inflation. The previous administration believed that the sustainable rate is slightly above 3 percent, close to Chairman Greenspan's estimates and within historical experience. Given these uncertainties, I have no reason to think that real growth of slightly more than 3 percent does not lie within the range of reasonable estimates of the sustainable rate of GNP growth.

Q2. The Reagan budget assumes a 3.5 percent GNP growth and that interest rates will fall by 2 points in 1989; does not the FED position place those two assumptions in conflict, i.e., if growth approaches 3 percent, the FED will raise interest rates? (It will certainly not bring interest rates down 2 points.)

A. As I indicated in my answer to the previous question, there is no conflict between the Federal Reserve and the Administration over the appropriate rate of real GNP growth this year. The Administration expects drought-adjusted real GNP to grow 2.8 percent between the fourth quarter of 1988 and the fourth quarter of 1989, below Chairman Greenspan's 3 percent. This 2.8 percent growth in drought-adjusted real GNP growth is slower than last year's growth and is consistent with declines in inflation and interest rates from last year's average levels. Further, Chairman Greenspan has stated, and I as well as most economists believe, that if and when a major budget deficit agreement is reached, interest rates are likely to fall.

Q3. Dr. Greenspan has noted that the current level of unemployment, which at 5.25 percent is the lowest in 12 years, represents a threat of inflation. Do you agree that 5.25 percent is as low as unemployment can safely go?

A. Estimates of the "natural," "full," or "nonaccelerating inflation" rate of unemployment are far from certain. Within the past seven years, some such estimates reached as high as 7 percent. The experience of the past three years indicates that it is significantly less than that, but exactly where it is currently is not clear. A number of factors are working in the direction of lowering both the frictional and cyclical components of unemployment. The aging of the population implies a more experienced labor force and lower turnover rates. Lower marginal tax rates on personal income encourage greater labor force participation. Greater competitiveness in markets has led to greater labor market flexibility. The relationship between the unemployment rate and changes in the inflation rate is not very precise, and given the uncertainties about the unemployment rate consistent with nonaccelerating inflation, should not be solely relied upon for policy guidance.

Chairman Greenspan indicated in his testimony that the range of uncertainty in estimating this concept is very large. He placed the lower end of this range at around 4-1/2 percent. In the U.S., historically, it has sometimes (with a different demographic pattern of the labor force and inflation history) been lower than that. In some countries, for example Sweden, unemployment is under 2 percent, while in others, for example much of Western Europe, unemployment is much higher than in the U.S. for similar rates of inflation. Many commentators blame the lack of flexibility in Western European labor markets for such high unemployment.

In summary, I am not convinced that unemployment can go no lower without a major reacceleration of inflacion, but I share Chairman Greenspan's concern that we be vigilant

against inflation reaccelerating. If we allow inflation to get much higher, the ultimate cost to reduce it again will be very large and should be avoided.

Q4. The size of the FSLIC deficit is sensitive to the salvage value of the properties of failed thrifts, many of which are located in areas of the country that have been in recession for many years. Do you see any regional recovery in the near future that might reduce the size of the FSLIC deficit?

A. Regional recovery is always a possibility, and would, of course, be most welcome. If it occurs, it could help address some of FSLIC's problems. At the same time, I believe we need to address some of the critical issues that have led to the current problems with the thrift industry in a timely manner. This means developing a plan for dealing with insolvent thrifts that adequately takes care of depositors, and that transfers ownership in a way that ensures that the problems with thrifts will be solved once and for all.

Q5. Part of the discussion of FSLIC funding options centers on whether to account for such funds on or off budget. Is there any practical economic difference between these two options?

A. There are two senses in which the source of funding can make important economic differences. First, the source of funding will affect who pays what share of the FSLIC's problem. Second, to the extent that the source of funding affects the way in which the S&L problem is addressed, it can also affect the potential size of the future liabilities that the government may incur.

Q6. Leveraged buy-outs and other forms of high-leverage corporate finance have raised the level of debt of corporate America to a new high. Some find this level alarmingly high. Do you?

A. It is important to put the problem of debt and, in particular, corporate debt in perspective. While public and private debt have been growing, and for certain sectors debt levels may present problems, overall debt has not reached levels that call for sweeping changes. The growth in assets has exceeded the growth in debt and therefore, household (and national) net worth has continued to increase in recent years. Corporate debt-equity ratios, when assets are valued at market prices rather than historical book value, are well below the peak levels of the mid-1970s. Also, while corporate net interest payments as a percentage of cash flow are rising, they are below the peak levels of the early 1980s.

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